Confronting Global Challenges

Policy Review and Outlook, 1987

C.D. Howe Institute

Edward A. Carmichael

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Foreword

The message of *Policy Review and Outlook, 1987* is an urgent one. When 1986 economic performance is put in perspective, two disturbing trends are discernible. The first is increased political anxiety and impatience in making economic policy, manifested in the poor coordination of macroeconomic policy and increasing protectionism. The second is the growing list of complex issues on the Canadian economic policy agenda, and the absence of a coherent strategic framework for that agenda.

Events in 1986, such as the drop in world oil and wheat prices, the plunge in the Canadian-U.S. dollar exchange rate, and a dramatic series of bilateral trade actions, illustrate the turbulence of the international economic environment and the associated risks of Canada's being blown off the best long-term policy course.

Looking ahead to 1987, growing protectionism and the uncertainties associated with often-chaotic U.S. macroeconomic policy pose additional risks to sustained growth.

Anticipating these risks requires a coherent policy framework in which trade and macroeconomic policies top the agenda. As was increasingly evident in late 1986, Canada needs a strategic view to manage its overall relationship with the United States at a time when that country's policymakers are frustrated and anxious about the United States' economic position in the world. In macroeconomic policy, deficit reduction should remain Canada's top priority because of the continuing danger that a loss of international confidence in U.S. policy could induce a world recession. Other key agenda items include those that will help to increase flexibility in Canada's economy: reform of taxes and social transfers, as well as improved labor market and industrial policies. There is a danger of agenda "overload". But this danger can be avoided if Canadian policymakers are patient and do not allow new global pressures in 1987 to blow them even further off course than they were in 1986.

The Institute's Director of Policy Research, Ted Carmichael, again has ably written this year's *Policy Review and Outlook*. He was assisted by Bruce Ewen, Policy Analyst. The manuscript was edited by Barry Norris and prepared by Cordelia Sharpe.

The conclusions presented here are based on a number of other studies released by the Institute in 1986 – listed at the back of the book – as well as on new research, which was reviewed with some of the members of the C.D. Howe Institute Policy Analysis Committee. These conclusions are the responsibility of Institute staff; they do not necessarily represent the views of outside authors or of the Institute's members or directors.

Wendy Dobson
President

1

Canada and the Turbulent World Economy

Canada's economy is like a ship sailing in turbulent international waters. The economic turbulence is created largely by factors outside Canada's borders and beyond Canadian control. The ship continues to move ahead but at a slower pace than during the past three years. Prospects for future progress are uncertain, for two reasons. First, the turbulence will continue and, if the United States does not adopt improved policies, it could get even worse. Second, though the overall attitude of the ship's crew has improved, its determination to cope with heavier seas is not assured.

The severe effects of the 1981–82 recession and the incomplete recovery to date have alerted many Canadians to the need to improve Canada's ability to compete internationally and to sustain growth in jobs and living standards. A start has been made. There was progress in 1986, but there were also setbacks, many originating abroad. The U.S. economy slowed in 1986. Protectionism intensified. Market prospects for a number of Canada's traditional exports of resource products continued to be weak.

In spite of an uncertain international environment, Canada has the potential to sustain domestic economic progress in 1987. This will require, however, further improvements in government policies and private-sector performance as international turbulence continues or intensifies. Policy responses to international pressures must be consistent with long-term objectives of achieving the competitiveness and flexibility necessary to sustain noninflationary growth. If they are not, they risk perpetuating some of the social and economic problems that persist after four years of economic expansion.

Canadians may be up to the task. They are certainly less complacent than at the beginning of the 1980s. They no longer assume that prosperity is their birthright. They increasingly realize that their future well-being in an interdependent global economy depends on their ability to anticipate future events, to compete, and to adjust.

Policy Review and Outlook, 1987 stresses that even though external developments constantly are reshaping the national economic policy agenda, Canadian policymakers must keep long-term economic objectives clearly in sight. At the same time, they should spare no effort in promoting solutions to the global economic imbalances that generate interna-

tional turbulence. To understand this turbulence and to interpret recent policy developments, we begin with a perspective on recent performance in the world and Canadian economies.

The World Economy

The expansion in the world economy will enter its fifth year in 1987. Though long by historical standards, this expansion has been uneven and remains incomplete, with wide variations in performance across countries, regions, and industrial sectors.

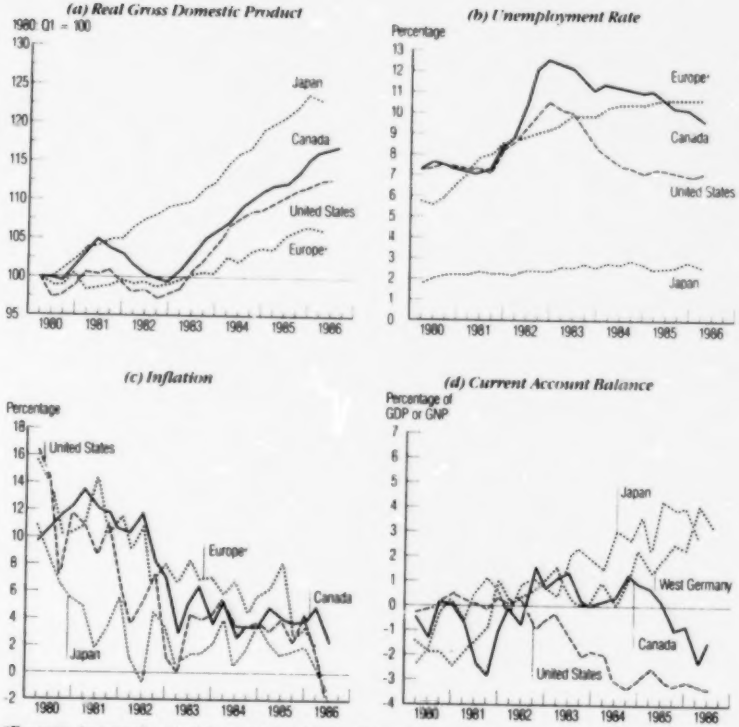
Following the severe 1981–82 recession, the large industrial economies have experienced steady economic expansion since early 1983, as shown in Figure 1, panel (a). Yet the expansion has been slow: the average growth rate has been considerably lower than in expansions of the 1960s and 1970s. Although all of the major industrial countries have had uninterrupted economic growth since 1983, Figure 1, panel (b), shows that it has not been strong enough to keep unemployment from remaining high. In the countries that make up the Organisation for Economic Co-operation and Development, 31 million people were unemployed in 1986, down slightly from the 1983 figure but up from 19 million in 1979. Among the large countries, only the United States has generated a spurt of growth that has been strong enough to raise employment to near the "full-employment" level. In Europe, growth has not been fast enough to keep unemployment rates from rising to double-digit levels. Even in Japan, where unemployment is low by international standards, the rate has risen since 1983. The persistent slack in labor markets also shows up in the continuing decline in inflation, illustrated in Figure 1, panel (c). Indeed, the International Monetary Fund was able to claim in 1986 that inflation had been conquered in the industrial countries, clearing the way for central banks to accommodate stronger economic growth.[1]

Differences in the pace of expansion among industrial countries have contributed to widening current account imbalances, as shown in Figure 1, panel (d). Although the U.S. dollar's appreciation during the 1980–85 period helped widen the U.S. trade deficit and increase Japanese and West German trade surpluses, more attention is now focused on the differences in growth rates among the United States, Europe, and Japan.

Early in 1986, the collapse in world oil prices, the continuing decline in interest rates, and the improved alignment of the U.S. dollar with other major currencies led many to expect stronger, more balanced economic growth among the industrial countries and reduced current account imbalances.[2] This optimism was short lived. A marked slowdown in growth

[1]International Monetary Fund, *Annual Report 1986* (Washington, D.C., 1986), pp. 1–8.
[2]See, for example, Organisation for Economic Co-operation and Development, *OECD Economic Outlook* (Paris, May 1986).

Figure 1
Economic Performance in North America, Japan, and Europe, 1980–86



*Europe, in panels (a), (b), and (c) refers to West Germany, France, the United Kingdom, and Italy.

Source: C.D. Howe Institute, based on data from Statistics Canada, U.S. Department of Commerce, Deutsche Bundesbank, Organisation for Economic Co-operation and Development, and International Monetary Fund.

in the first half of 1986 showed that the movements in oil prices, interest rates, and exchange rates were at least as much a sign of current economic sluggishness as of expected future strength. Instead, the widening U.S. trade deficit fueled protectionist fires in that country and contributed to a sharp reduction in the growth of world trade, which slowed to about 3 percent in both 1985 and 1986 from 9.5 percent in the recovery year of 1984.[3] As growth of domestic demand has slowed in the United States, economists have identified two very different scenarios for the future.

The first scenario is an optimistic one, based on the view that the industrial economies are experiencing normal but variable lags in response to sharp movements in commodity prices, interest rates, and exchange rates.[4] According to this view, the West German and Japanese economies finally should show the beneficial effects of lower oil prices and mild fiscal and monetary stimulus. With stronger growth abroad and a lower U.S. dollar, the U.S. trade deficit should improve by the end of 1986 or early 1987 and bring with it stronger U.S. economic growth. In this environment, and with the U.S. congressional elections completed, protectionism should diminish and growth in world trade should reaccelerate.

A second, more pessimistic, scenario interprets the pause in the first half of 1986 as foreshadowing a slide into recession.[5] In this view, the United States' failure to make significant progress in reducing its government budget deficit has created an international environment in which recession is increasingly likely. As is explained in Chapter 3, the combination of a sharply lower U.S. dollar and the persistence of large U.S. budget deficits risks a major downturn in private investment. If West Germany and Japan remain reluctant to adopt measures to accelerate domestic demand, the slowdown in the U.S. economy is unlikely to be offset by stronger growth abroad. In this environment, protectionism would flourish, growth in world trade growth would diminish, and the world economy would stagnate.

These widely different scenarios suggest a range of possible economic developments in 1987. The opportunity for continued growth and diminished economic imbalances exists if governments in the major industrial countries have the patience and wisdom to pursue constructive policies. But patience is in short supply and wisdom can be overruled by domestic political pressures. For these reasons, the worldwide expansion is at risk in 1987.

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[3]General Agreement on Tariffs and Trade, *International Trade 1985/86* (Geneva, 1986).
[4]The International Monetary Fund adopted this view at its annual meeting in September 1986. See Jennifer Lewington, "IMF sees stabilizing trend, new growth in global economy," *Globe and Mail* (Toronto), September 30, 1986, p. B14.
[5]Stephen Marris expresses this view in his book *Deficits and the Dollar: The World Economy at Risk* (Washington, D.C.: Institute for International Economics, 1986). For a discussion of Marris' and other interpretations of the interrelationships among exchange rates, capital flows, and trade, see "Symposium," *Brookings Papers on Economic Activity* (1986:1): 165–235.

The Canadian Economy

In some respects, Canada's recent economic performance has been among the best in the industrial countries. Growth in real GNP and in total employment have been stronger in Canada since the end of 1982 than in the United States, Japan, or Europe. Both inflation and unemployment have declined significantly during the same period. Unlike other industrial countries, Canada has achieved relative stability in its current account balance. Yet Canada's economic expansion has mirrored that of the world economy. It has been uneven across industrial sectors and regions. It has been incomplete in that the sharp increases in unemployment and poverty that accompanied the 1981–82 recession have been reversed only partially.

Table 1
Financial Indicators for Canadian Resource and Nonresource Industries, 1980, 1985–86

	1980	1985	1986
			1st half
Nonresource industries			
Real return on assets[a] (percent)	0.8	7.1	7.3
Debt-equity ratio	1.08	0.99	0.99
Interest coverage ratio	2.9	2.7	2.6
Capital expenditures[b] (1981 $ billions)	19.4	17.8	19.7
Resource industries			
Real return on assets[a] (percent)	6.7	8.1	5.3
Debt-equity ratio	0.53	0.74	0.82
Interest coverage ratio	7.9	3.4	2.4
Capital expenditures[b] (1981 $ billions)	13.3	10.8	9.6

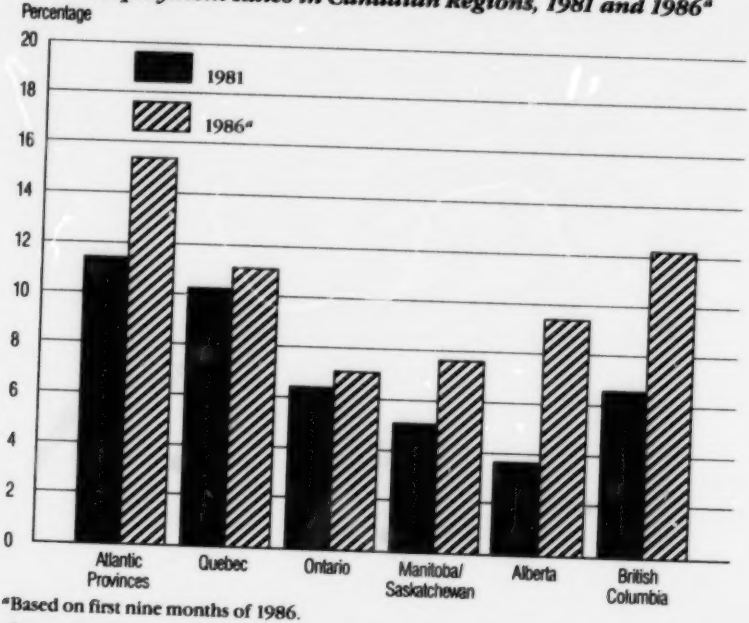
[a] Deflated using the implicit deflator for gross domestic product.
[b] Deflated using the implicit deflator for business fixed investment.

Source: Department of Finance, *Quarterly Corporate Sector Report, Reference Supplement*, various issues.

The dual nature of the Canadian economy was very much in evidence in 1986. Central Canada's manufacturing and services industries boomed while Atlantic and Western Canada's natural resource industries remained depressed.[6] World markets called very different economic tunes for the different regions. Basic prices of natural resources, in decline since the early 1980s, went into a tailspin with sharp drops in oil and grain prices in early 1986. In mid-1986, energy resource prices stood 45 percent below their level of a year earlier, nonenergy resource prices and prices of industrial products were unchanged, and consumer prices were up by 4 percent.

[6]For a detailed discussion of recent regional economic development in Canada, see Edward A. Carmichael, *New Stresses on Confederation: Diverging Regional Economies*, Observation no. 28 (Toronto: C.D. Howe Institute, 1986).

Figure 2
Unemployment Rates in Canadian Regions, 1981 and 1986[a]



[a]Based on first nine months of 1986.

Source: Statistics Canada, *The Labour Force*, Cat. no. 71-001, various issues.

Table 1 shows the financial impact of weak natural resource prices on Canadian industry. In the nonresource industries, several major indicators show improved financial health. Real return on assets has improved; debt-to-equity ratios have declined; coverage of interest payments out of cash flow remains adequate; capital spending has increased. In the resource industries, by contrast, the indicators for the first half of 1986 show a deterioration of financial health, resulting in part from the drop in oil prices. Some bright spots exist in the resource sector — precious metals, pulp and paper — but in general, both prices and volumes have declined in a fiercely competitive international environment. By late 1986, resource prices appeared to have stabilized, with the prospect of modest improvement in 1987.

The decline in raw material prices has produced a major reversal in the economic well-being of residents in several different regions of Canada. Figure 2 shows that unemployment rates in Ontario and Quebec in 1986 were near prerecession levels of 1980, while elsewhere in the country they range from 40 percent above 1980 levels in the Atlantic provinces to 150 percent higher in Alberta.

The Underside of the Expansion

The failure of the Canadian economy to grow fast enough to bring unemployment down across the country to prerecession levels has exposed an underside of the current expansion. Some Canadians have not yet received much benefit in the way of stable employment and higher incomes. The inflationary excesses of the late 1970s and the deep 1981–82 recession continue to impose social costs, including long-term unemployment, high unemployment for young people, and increased poverty.

In spite of a decline in the overall unemployment rate, the problem of long-term unemployment has improved little. Table 2 shows that in 1979, fewer than 4 percent of those unemployed in Canada had been out of work for more than a year. By 1984, this figure had increased to almost 10 percent. In spite of falling to 9.3 percent in 1985, long-term unemployment remains more than twice as prevalent today as it was at the beginning of the decade. Long-term unemployment, until a few years ago mainly confined to older workers, now affects many young people and prime-aged workers as well. This is a disturbing development because long-term unemployment tends to trap people outside the mainstream of the labor market. Skills and motivation can deteriorate with long spells of unemployment, while dependence on unemployment insurance (U.I.) and short-term jobs to maintain U.I. eligibility increases.

Unemployment among young people also remains a concern, but one whose nature is changing. Youth unemployment, which was almost 20 percent in 1983, fell to 15.4 percent in 1986. But in spite of this improvement, youth unemployment has not declined by as much as might have been expected in light of the steady decline in the number of young people in the labor force. At the same time, many of those who were unemployed youths in the 1981–83 period are now 25-to-30-year-olds with little work experience and are the source of persistent high unemployment in that age group. As David Foot and Jeanne Li of the University of Toronto point out, unemployment in this group is not so much a problem of youth as one of a particularly large cohort of people born between 1955 and 1960.[7]

The incidence of poverty in Canada also has increased in the 1980s. The most recent figures show that 3.9 million Canadians had incomes below the poverty line in 1985, an increase of 500,000, or 12 percent, since 1980. As shown in Figure 3, the percentage of Canadians below the poverty line increased significantly from 1981 to 1984 and began to diminish in 1985. Certain groups are particularly vulnerable to poverty:

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[7]David K. Foot and Jeanne C. Li, "Youth Unemployment in Canada: A Misplaced Priority?" Policy Study 85-7 (Toronto: University of Toronto, Institute for Policy Analysis, July 1985).

Table 2
Long-Term and Youth Unemployment in Canada, 1979–86
(percentage)

	Long-term unemployment		Youth unemployment		
	6 months and over	12 months and over	Number ('000s)	Rate	Share of total unemployment
1979	15.6%	3.5%	388	12.9%	46.6%
1981	16.1	4.2	408	13.2	45.4
1983	28.0	9.5	578	19.9	40.0
1984	26.0	9.9	517	17.9	36.9
1985	25.5	9.3	472	16.5	35.6
1986[a]	n.a.	n.a.	443	15.4	35.6

[a] Based on first nine months of 1986.

Sources: Statistics Canada, *Labour Force Statistics*, Cat. no. 71–201; Gary L. Cohen, "Industry and Occupation Trends in Long-Term Unemployment," in Statistics Canada, *Labour Force Survey*, Cat. no. 71–001, June 1986, pp. 89–113; and *OECD Employment Outlook* (Paris, September 1985).

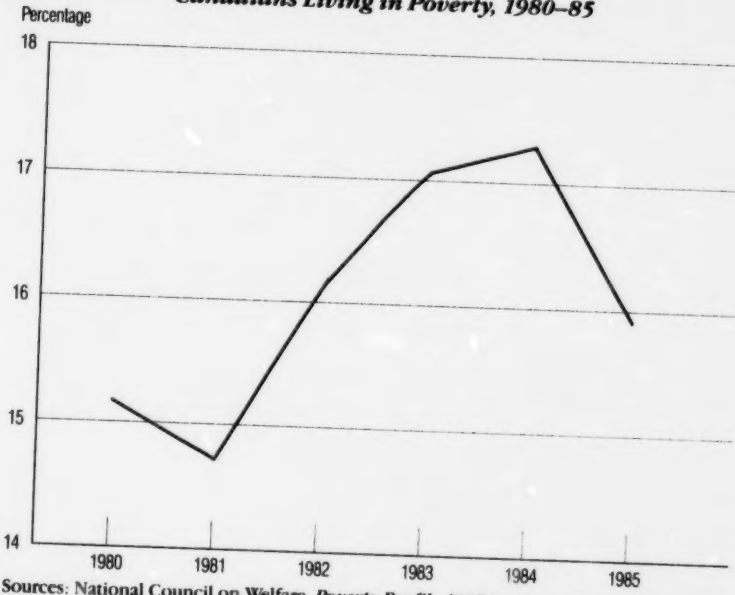
single-parent families, families with three or more children, and families headed by persons under 25 experienced increased incidence of poverty in the early 1980s. The number of children living in poor households increased to 1,200,000 in 1984 from 900,000 in 1980.[8]

These statistics illustrate that, in spite of almost four years of economic expansion, some sectors and regions and many families in Canada still have not regained ground lost during the 1981–82 recession. The expansion cannot be considered satisfactory until its benefits are spread more broadly and evenly. Achieving this objective will require efforts on a broad range of policy fronts. Sustaining economic growth is a necessary condition for further reductions in unemployment and poverty. But growth, by itself, is unlikely to resolve the problem. As we have pointed out in previous issues of *Policy Review and Outlook*, unemployment in all of the industrial economies has become more a structural and less a cyclical phenomenon in the 1970s and 1980s. Higher structural unemployment in Canada is perhaps mainly due to new technologies and global shifts in comparative advantage. But it also reflects a failure of Canada's labor market policies.

The interaction, for example, between short-term government job-creation programs and the operation of the U.I. system contributes to the persistence of high unemployment, as two government commissions — one at the national level and one in Newfoundland —

[8]National Council of Welfare, *Poverty Profile, 1985* (Ottawa: Supply and Services Canada, 1985).

Figure 3
Canadians Living in Poverty, 1980–85



Sources: National Council on Welfare, *Poverty Profile 1985* (Ottawa: Supply and Services Canada, 1985), p. 7; Statistics Canada, *Income Distribution by Size, Preliminary Estimates 1985*, Cat. no. 13-206 (Ottawa, 1986), p. 9.

point out.[9] Under the current system, it is possible in many parts of the country to work for ten weeks and qualify to receive U.I. benefits for the rest of the year. In areas of the country where the number of unemployed far exceeds available jobs, this system creates an incentive for governments to provide short-term jobs to enable local residents to requalify for U.I. benefits. This results in a costly cycle of dependency that can be broken only by reform of unemployment insurance and improvement of other human resource and income security policies.

Initiatives in other policy areas also can be instrumental in reducing unemployment and poverty. Canada's decision to pursue comprehensive reform of the tax system and of social programs could improve work incentives and help the working poor to escape the "poverty trap" that the existing system has created. As U.S. protectionism builds, Canada's

[9]Canada, Commission of Inquiry on Unemployment Insurance, *Report* (Ottawa, forthcoming); and Newfoundland, Royal Commission on Employment and Unemployment, *Building on Our Strengths* (St. John's, 1986).

initiatives in bilateral and multilateral trade negotiations become increasingly important for maintaining jobs in Canada. Industrial policies that focus on improving Canada's competitive position and providing a positive climate for new business start-ups also can play a positive role. With these possibilities in mind, we now turn to an examination of recent policy developments in Canada.

Economic Policy in 1986

The international environment in 1986 was an extremely difficult one. Falling prices for oil and wheat, speculation against the Canadian dollar, and the rising tide of U.S. protectionism limited the ability of private and public decisionmakers to improve Canada's economic performance. Past delays in restoring fiscal policy flexibility and in encouraging adjustment to rapidly changing world market conditions left policymakers with little room to maneuver.

The federal government continued to make progress in 1986 in identifying and initiating elements of an overall economic strategy. An encouraging aspect of economic policy in 1986 was the continuing movement toward policies that reinforce competitive market behavior in key sectors of the Canadian economy. In macroeconomic and trade policy, however, progress proved more difficult.

Sectoral Policies

A central element of economic policy since 1984 has been the removal of obstacles to competition and the more vigorous operation of market forces within the Canadian economy. In 1986, important sectoral policy developments occurred, which, while attracting little public attention, were integral steps in improving Canada's longer-term prospects.

In transportation, deregulation and a new *National Transportation Act* promise to enhance competition and reduce costs in the airline, rail, and road transport sectors. The old rules required firms to demonstrate public convenience and necessity to gain entry to these industries. Under the new law, firms need demonstrate only that they are "fit, willing, and able." Firms that can meet safety requirements will be able to enter and compete with existing firms. To prevent undue disruption, the new rules are being phased in gradually but, eventually, increased competition from new Canadian entrants and from U.S. transport firms will be allowed.

In the natural gas sector, moves to deregulate prices already are responsible for the creation of markets and competitive prices where none existed as recently as a year ago. The key to the liberation of this sector was the conversion of TransCanada PipeLines Limited from the major purchaser of natural gas to a common carrier. Under the new arrangement,

natural gas producers and brokers can sell directly to major purchasers in consuming industries and pay TransCanada PipeLines a fee for pipeline transportation. The result has been growing competition in natural gas pricing. The outbreak of competition is striking evidence of the ability of both producers and consumers to adapt, given framework policies that encourage market-responsive behavior.

In the securities industry, an Ontario government proposal to relax restrictions on ownership of Canadian securities firms by foreigners and by Canadian nonfinancial firms represents a first, albeit partial, step toward enhancing Canada's ability to compete in highly competitive international capital markets.[10] Gradually opening up the Canadian securities industry to increased foreign competition and fewer restrictions on ownership could increase the ability of Canadian firms to attract new capital and develop a greater international presence. As the globalization of capital markets continues, policymakers need to realize that financial market regulations have to encourage Canadian firms to compete internationally or risk an erosion of their share in world financial activity and a less efficient capital market in Canada.

Government also deserves some good marks for policy decisions that responded to the severe problems of the oil and agricultural sectors. Because oil exploration is concentrated in Alberta, Saskatchewan, and the Atlantic offshore region, and because agriculture is concentrated in Western Canada, sectoral problems created regional problems as well. The severe impact that the collapse of oil and grain prices had on resource-producing regions rekindled a debate on the design of effective regional policies that is as old as Confederation. Within their limited fiscal capacity, the federal and provincial governments made some wise choices in dealing with sectoral and regional problems in 1986. They chose to cushion the blow of a 50 percent drop in the world oil price by reducing taxes and royalties, rather than by imposing a "floor price" that would have blocked needed adjustment to the new world price. In agriculture, the federal government maintained the same principle when it cut the fuel tax for farmers. It violated the principle, however, when it set a floor price on domestic grain sales, and then apparently abandoned the principle altogether when it announced $1 billion in undefined agricultural support.

It remains to be seen whether the renewed focus on regional policy will prove a welcome one. The need to promote sectoral and regional adjustment is clear, as is the need to cushion temporarily the impact of sharp changes in world market conditions on individuals who bear the

[10]See Thomas J. Courchene, with John D. Todd and Lawrence P. Schwartz, *Ontario's Proposals for the Canadian Securities Industry*, Observation no. 29 (Toronto: C.D. Howe Institute, 1986).

burden of adjustment. Yet, the attraction persists to use gimmicks, such as rich tax incentives for investment in Cape Breton Island and costly provincial subsidies to secure offshore investment in, for example, automobile assembly plants. It would be unfortunate if the painful lessons of 1986 do not lead to improved long-term sectoral and regional policies that encourage adjustment.

Macroeconomic Policies

The tone for macroeconomic policy was set early in 1986 when the decline in the world price of oil and uncertainty in financial markets about the federal government's commitment to deficit reduction led to a speculative run against the Canadian dollar. As the dollar declined in February to a postwar low of U.S.$0.69, the Bank of Canada pushed up Canadian short-term interest rates by almost 3 percentage points.[11] Some depreciation of the Canadian dollar may have been warranted, given that the weakness of natural resource prices and other factors were causing Canada's current account balance to deteriorate. Even if one accepts this view, however, the Bank also was constrained by trade policy considerations. Allowing the Canadian dollar to fall to, say, U.S.$0.65 might have provided a temporary competitive advantage for Canada, but easily could have contributed to already strong protectionist pressures toward Canada in U.S. industry and in the U.S. Congress.

The dollar's depreciation, which began in November 1985, meant that Finance Minister Michael Wilson's options in the February 1986 budget were limited. Failure to reinforce the government's plans to reduce the federal deficit could have set off a new round of speculation against the dollar. The budget did provide a fiscal plan that was capable of meeting the medium-term target of stabilizing the growth of federal debt in line with that of the economy by the end of the decade. Yet, by September, Finance Minister Wilson had to announce that a revenue shortfall caused by an unanticipated slowdown in growth and the need to cushion the impact of lower grain and oil prices would push up the current year's deficit to $32 billion from the $29.5 billion projected in the budget.

Although the minister re-emphasized his commitment to the medium-term target established in the February budget, he left unanswered the question of how much the fiscal year 1986–87[12] revenue shortfall would alter the fiscal plan. To answer this question, it is necessary to identify the main sources of the revenue shortfall. There are two.

The first is the loss of energy revenues associated with the drop in energy prices and the decision in September 1986 to eliminate the Petroleum and Gas

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[11]For the Bank of Canada's rationale for its actions, see Gerald K. Bouey, "Address by the Governor of the Bank of Canada to the Canadian Club of Vancouver," June 20, 1986; reprinted in *Bank of Canada Review*, June 1986, pp. 15–21.

[12]"Fiscal year 1986–87" refers to the federal government's fiscal year, which ends on March 31 — that is, the period from April 1, 1986, to March 31, 1987.

Revenue Tax (PGRT). Although the loss of energy revenues will average $600 million per year for three years, it has no impact on revenues beyond 1989, when the PGRT was previously scheduled to be phased out.

The second is the loss of corporate tax revenues associated with lower-than-expected corporate profits and with an erosion of the corporate tax base as a result of business loss carry-forward provisions introduced in 1983.[13] If depressed commodity prices continue to hold down corporate profits and the erosion of the tax base remains unchecked, the corporate tax shortfall will persist. Assuming that it will, the government's deficit and debt projections will be altered as shown in Figure 4. If the government sticks to expenditure controls announced in the February 1986 budget and if projections of other sources of federal revenue remain on track, it may not have been blown significantly off the course set in its medium-term fiscal plan. The deficit will still drop to about 4 percent of GNP by fiscal year 1990–91 from about 9 percent in fiscal year 1984–85. Similarly, the debt-to-GNP ratio will stabilize at just over 55 percent of GNP by the end of the decade. The message of this analysis is that the deficit-reduction plan introduced in the February 1986 budget remains credible if the assumed economic performance that underlies the projections can be met. The government thus made progress in moving toward a sustainable fiscal policy in 1986.

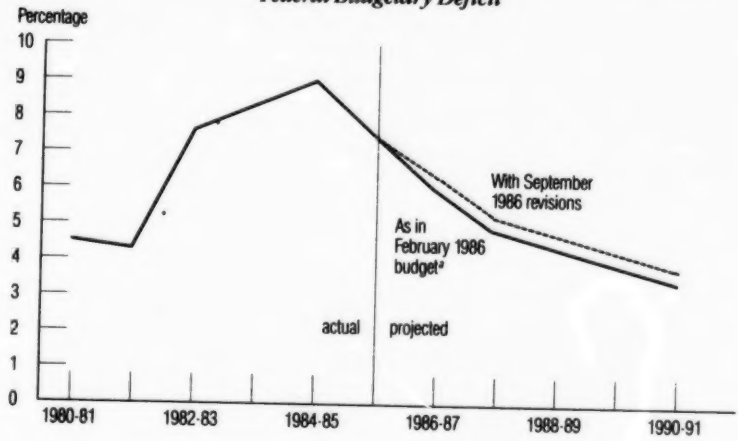
Trade Policy

Canada's trade policymakers also faced tough choices created by external pressures in 1986. U.S. protectionist pressures, which had been building for several years, hit Canada with force in 1986. Early in the year, the United States imposed countervailing duties on the Atlantic groundfish industry. In June, the Reagan administration used emergency safeguard rules to impose a 35 percent tariff on Canadian cedar shingles and shakes. Canada retaliated by imposing tariffs on several goods imported from the United States, an action that did not go unnoticed in Washington or abroad. The U.S. Commerce Department's preliminary decision to impose a 15 percent countervailing duty on Canada's $4 billion worth of softwood lumber exports brought Canadian charges of "trade harassment" and a complaint to the Secretariat of the General Agreement on Tariffs and Trade (GATT) that the United States' use of countervail was not consistent with GATT intentions and principles. Statements by U.S. Trade Representative Clayton Yeutter that Canada had broken a commitment to restrain steel exports to the United

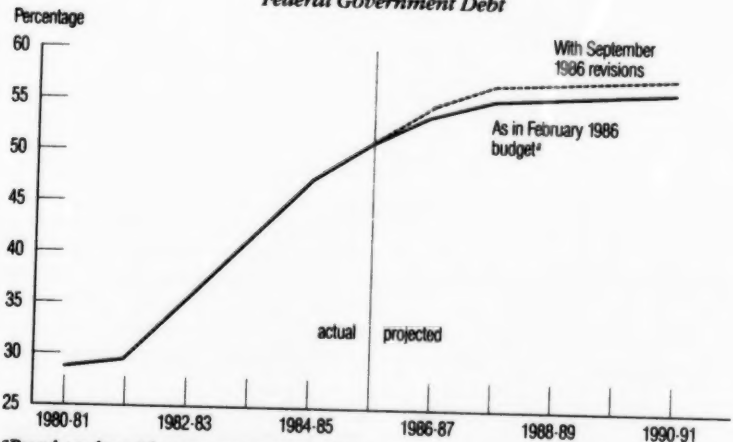
[13]The April 1983 budget introduced changes to loss carry-over provisions in the personal and corporate income tax systems "to enhance the ability of businesses to carry over losses in one year to reduce tax in other years." The time period for carrying losses backward to previous tax years was extended from one to three years. The period for carrying losses forward to future tax years was extended to seven from five years. See Department of Finance, ***Budget Papers*** (Ottawa, April 1983), p. 27.

Figure 4
Federal Budgetary Deficit and Debt, fiscal years 1980-81 – 1990-91
(percentage of GNP)

Federal Budgetary Deficit



Federal Government Debt



[a]Based on the mid-range economic outlook.

Sources: C.D. Howe Institute; and Department of Finance, *The Fiscal Plan* (Ottawa, 1986), pp. 47, 119, 128.

States and by Treasury Secretary James Baker that Canada was artificially holding down its exchange rate were countered with public messages and behind-the-scenes attempts to set the record straight.

Trade policymakers also faced a near collapse of the multilateral trade talks when the 92 member nations of the GATT met in Uruguay in September. At that meeting, Canada promoted its key objectives of bringing an end to damaging agricultural export subsidies and controlling the application of countervail and other contingent-protection measures. In the end, compromises and some watering down of the specific objectives saved the "Uruguay Round". The agenda of the new round of trade talks will include issues of concern to Canada, but early results in restoring some order to the world trading system are unlikely. For this reason, multilateral talks continue to take a back seat to Canadian-U.S. trade talks and trade frictions.

Looking Ahead to 1987

Economic pressures arising from events and decisions taken outside Canada's borders can be expected to continue to play a central role in influencing Canadian economic performance and policy in 1987. There is a risk in this environment that Canadians will conclude that they have only limited ability to shape their own national economic future. This conclusion would be incorrect and damaging to Canada's longer-term prospects. The challenge in 1987 will be to create an attitude among Canadians that, as global economic interdependence increases, Canada's future success depends more than ever on wise decisions at home. This means decisions by Canadian business to innovate and seek out new opportunities, both at home and in foreign markets. It means decisions by the Canadian trade union movement to adopt pragmatic and open-minded approaches to national economic issues. It means decisions by governments to press ahead with international policies that create a climate for sustained, noninflationary growth, that enhance Canada's access to and competitiveness in world markets, and that ultimately increase Canada's economic policy independence.

The federal government already has taken some of the essential steps. The elements of an economic strategy are there. The vision of how the individual elements can create an overall strategy for economic success began to emerge in the government's November 1984 *Agenda for Economic Renewal*, but that vision has since been blurred by events. The government's failure, in the October 1986 Throne Speech and on other occasions, to fit the elements together into a cohesive strategy jeopardizes the progress made to date in individual policy areas. Pressure on the government to react to a difficult international economic climate further jeopardizes progress.

The vision, were it in clear focus, would be one of Canada as an open, adaptable economy with a private sector able to identify market niches, innovate, and compete in the global economy. Building this self-image in 1987 will require that Canadians confront head on international pressures and tough domestic issues. The challenge will be to pursue individual policy initiatives as part of a larger strategy for success. In macroeconomic policy, the objective will be to sustain noninflationary economic growth in an uncertain world economic environment. In trade policy, the objective will be to manage effectively trade frictions with the United States while pursuing bilateral and multilateral agreements to reverse the rising tide of protectionism. In tax and transfer policies, the objective will be to bring about an orderly and effective reform of Canada's tax and unemployment insurance systems in ways that improve the climate for growth.

Outline of the Policy Review and Outlook

Chapter 2 assesses what is likely to be the dominant domestic economic policy issue in 1987: reform of the tax system and related social transfers. The chapter argues that two distinct agendas for reform already can be identified, each generating a different set of expectations about the final outcome. It proposes a general four-step process of tax reform that would achieve the major objectives of both agendas. At the same time, it argues, tax reform should be an evolutionary process tailored to Canadian objectives, rather than a rush to copy U.S. tax reform.

Chapter 3 examines in detail the global economic challenges confronting Canada in 1987. It suggests that although the economic expansion is likely to continue in 1987, without better coordination of macroeconomic policies global trade and budgetary imbalances will persist, increasing the risks of protectionism and other policy mistakes. Canada's leaders may comprehend the risks but they have not yet articulated a coherent strategy to respond to an uncertain world environment.

Chapter 4 discusses key policy issues facing federal and provincial governments in 1987 and outlines a policy strategy for Canada in a changing and interdependent world. In some policy areas — deficit reduction, tax and unemployment insurance reform, and industrial policy — the only constraints on improved policy are domestic pressures to maintain the status quo. In other areas — macroeconomic and trade policy — Canada's options are influenced by the actions of other countries and by the need to improve international policy coordination and to strengthen the world trading system.

2

Realistic Expectations for Tax Reform

> *"I keep thinking to myself, 'We ain't in Kansas anymore, Toto!'"* — U.S. business executive on tax reform, August 1986.

On July 18, 1986, Finance Minister Michael Wilson announced the federal government's plans to review options for comprehensive tax reform. The announcement signaled an important change from the gradual, multitrack approach to tax reform that the government had been pursuing since the May 1985 budget. It also foreshadowed, by only a few weeks, a dramatic U.S. congressional agreement for a comprehensive reform of that country's tax system. In the process, reform of Canada's tax system was catapulted from a technical debate by tax specialists to a popular political issue.

The tax system is an important determinant of the economy's long-term ability to adjust and grow. Taxes, along with government transfer programs, play a crucial role in influencing the structure of incentives facing firms and employees in the private sector. These incentives, in turn, shape decisions to work and save, to undertake risk, and to adjust to change. The existing tax system contains a hodgepodge of incentives that pushes individuals and firms in directions that damage Canada's long-term growth prospects. High marginal tax rates and the incentive-dulling effects of transfer payments discourage labor-market activity. Special tax provisions make profitable some investments that are inefficient and wasteful in a business sense. The result is a misallocation of scarce capital, which reduces productivity and long-term economic growth.

To those who have been arguing for some time that reform of the tax and personal transfer system is critical to improved long-term economic performance, the newly found popularity of tax reform is at once both encouraging and worrisome.[1] It is encouraging because it means that tax reform will

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[1] In last year's *Policy Review and Outlook*, the Institute argued that:

> Gradual reform of Canada's tax and transfer system could help meet the strategic objectives of encouraging initiative and growth, and could help bring the federal budget deficit under control. . . The piecemeal changes the federal government is considering. . . are not the result of a comprehensive strategy to reduce distortions and other problems created by the existing system. . . Our assessment of the problems. . . suggests to us. . . that a more comprehensive strategy for reform of the tax and transfer system is required.

Edward A. Carmichael, *Reorienting the Canadian Economy*, Policy Review and Outlook, 1986 (Toronto: C.D. Howe Institute, 1985), p. 72.

be debated within a broader framework of economic objectives. It is worrisome in that the U.S. decision has raised expectations among Canadians that may be unrealistic. Differences exist in the two countries' structures of government expenditures and revenues, reflecting differences in their philosophy, history, and expectations of government. Canadians now must decide to what degree differences between Canada's tax system and that of the United States are both desirable and tolerable.

This chapter outlines the reasons why comprehensive reform of Canada's tax system has emerged as the leading domestic economic policy issue of 1987. It then identifies two distinct agendas for Canadian tax reform, each generating its own expectations for the final outcome. Finally, the chapter proposes a general approach to tax reform that could provide the basis for a consensus and help focus the tax reform debate on important issues of tax structure, distribution of the overall tax burden, and transitional arrangements.

Imperatives for Reform

In a speech to a U.S. tax conference, the Minister of Finance laid out four "fundamental objectives" of comprehensive tax reform in Canada:

- it should provide sufficient revenues to finance government programs;
- it must be appropriate for the country's economic structure;
- it must reflect the basic values of society; and
- it must maintain the respect of the taxpaying public.[2]

While these are reasonable objectives, their achievement is not the operative driving force behind the decision to broaden and speed up tax reform in Canada. Three fundamental imperatives will determine the specific objectives and minimum requirements of a successful tax reform package.

The first is the *competitiveness imperative*, which is based on the recognition that reform in the United States opens up major differences between the U.S. and Canadian tax systems. U.S. tax reform contains four key elements: a significant broadening of both the personal and corporate income tax bases through the elimination of a wide range of exemptions and deductions; a major reduction and simplification of tax rates; a shift in the overall tax burden away from personal income and toward corporate income; and the removal of at least six million low-income taxpayers from the tax rolls. Worries emerged almost immediately in Canada about "brain drain" and "capital flight" to the United States because of

[2]Hon. Michael H. Wilson, Notes for remarks to the American Council for Capital Formation, Consumption Tax Conference, Washington, D.C., September 5, 1986, p. 2.

lower tax rates in that country. These are valid worries, and in spite of the fact that they are sometimes overstated, they do put pressure on the federal government to keep differences in the Canadian and U.S. tax systems within tolerable limits.

The second factor driving Canadian tax reform is the ***deficit/debt imperative***. Although important steps have been taken since November 1984 to slow the explosive growth of the federal debt, events in 1986 again threatened the ability of the federal government to meet its medium-term deficit-reduction and debt-management targets. To achieve its fiscal targets, the federal government's revenues will have to grow at an annual rate of 8 percent in the second half of the 1980s, twice the rate of federal expenditures. Yet Finance Minister Wilson's September 1986 budget update raised legitimate concerns that the current system of federal tax bases and rates may be incapable of meeting federal revenue targets. The role of tax reform in this context is not to increase the government's revenue targets but simply to make current targets attainable.

The third factor is the ***political imperative*** created by the U.S. tax reform bill. The package has obvious political appeal because it lowers personal taxes for the majority of low- and middle-income individuals — that is, for the majority of voters. The reform's political architects promoted it as a routing of special-interest lobbies in favor of the average taxpayer. By eliminating many special tax provisions, the changes will simplify the U.S. tax system considerably. By reducing tax shelters and increasing the basic exemption, the changes also will improve the perceived fairness of the system.

Prior to the U.S. tax reform, it was acceptable in Canada to move in a gradual and piecemeal fashion to deal with the problems of eroding tax bases, rising tax rates, increasing complexity, and the perceived unfairness of the tax system. That option is no longer viable — either economically or politically. Powerful as the imperatives are and urgent as the need for comprehensive tax reform in Canada is, it would be unwise to move too hastily. To be successful, tax reform will have to ensure the competitiveness of the Canadian system yet meet unique Canadian economic objectives and societal values. While the case for tax reform in Canada is compelling, there is a risk that public discussion will bog down in sterile debates about how much tax revenue should come from Canadian workers and how much from business. At the outset, it is worth noting that, in the end, individual Canadians bear the burden of all taxes. This is obviously true of personal taxes. But it is also true of taxes on corporations, which are borne partly by individual consumers in higher prices, partly by individual shareholders in lower after-tax returns, and partly by individual workers in lower wages. This does not mean that the way taxes are collected is unimportant. On the contrary, it means that

attention to the design of individual taxes and of the overall system should focus on the important issues of promoting neutrality in the tax system and flexibility and growth in the Canadian economy.

Two Agendas

The sweeping changes in U.S. tax law that take effect on January 1, 1987, seem to provide a clear example for other countries, including Canada, of a reform that is economically beneficial and politically popular.[3] It is already possible, however, to discern the development of two distinctly different approaches to reform in Canada. One approach — responsible for the increased political interest in tax reform — can be termed the populist agenda. The other approach — in place well before the dramatic breakthrough in the United States — can be termed the tax policy agenda. Expectations for tax reform based on these two agendas differ significantly.

The Populist Agenda

Popular concerns about Canada's current tax system — that is, concerns of taxpayers, rather than of tax policy specialists or tax practitioners — are the basis of the populist agenda. The most important of these concerns relate to the burden, complexity, and fairness of the system.

• *The tax burden*. There is a growing perception that individuals — particularly those in the middle-income bracket — have been shouldering an increasing tax burden. A recent study by the Canadian Tax Foundation confirms that the perception is accurate.[4] As Table 3 shows, average and marginal tax rates have steadily increased since 1969 both for families and for single individuals in the middle-income range. The increase in the tax burden has two causes. First, increasing real incomes have moved the average taxpayer upward through the progressive tax-rate structure. Second, the rate structure itself has been increased by government policy decisions. The Canadian Tax Foundation estimates that each of these two sources has contributed about half of the increase in the tax burden of middle-income individuals.

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[3]The jury is still out, of course, on whether the U.S. tax reform will generate significant economic benefits. It will shift tax burdens among industries and individuals, with little in the way of meaningful transition arrangements. The ultimate effects on economic performance are very difficult to forecast. For a useful discussion, see Joseph Minarik, "Tax Reform — What Does It Mean?" *Urban Institute Policy and Research Report* 16 (August 1986): 1–6.

[4]Janet L. Ballantyne, "The Tax Burden of the Middle-Class Canadian," *Canadian Tax Journal* 34 (May–June 1986): 671–680.

Table 3
Estimates of the Canadian Middle-Income Tax Burden, Selected Years, 1969–86

Year	Tax payable (dollars)	Average tax rate (percent)	Marginal tax rate (percent)
Family[a]			
1969	$1,485	16.2%	28.7%
1978	4,190	18.7	35.1
1983	6,855	19.8	36.8
1986	8,655	22.2	37.1
Single individual			
1969	1,915	20.8	26.8
1978	4,815	23.3	35.8
1983	8,290	25.1	36.8
1986	9,860	26.6	37.1

[a] Married couple, one income earner, two dependent children.

Source: Janet L. Ballantyne, "The Tax Burden of the Middle-Class Canadian." *Canadian Tax Journal* 34 (May-June 1986): 675–676.

• *Tax complexity.* There is a perception that the complexity of the tax system has grown to the point where many people can no longer understand and prepare their income tax returns without the assistance of a tax specialist. Over 100 exemptions, deductions, and credits are available to individual taxpayers, many of them used by only a small number of people. The complexity of the tax system appears to increase the burden on ordinary taxpayers who do not obtain advice on how to arrange their affairs in ways that legally avoid tax.

• *Tax unfairness.* The perception is widespread that the tax system is unfair to the average taxpayer. Some people argue that the system favors wealthy Canadians, in several ways. First, although recent budgets have eliminated some tax shelters and the imposition of a minimum tax has reduced the effectiveness of others, tax shelters are still perceived to benefit wealthy individuals unfairly. Second, the introduction of the lifetime $500,000 capital gains exemption and the proposed increase in Registered Retirement Savings Plan contribution limits to $15,500 per year are widely perceived as conferring benefits primarily on the wealthy. Third, many see the rising share of government revenues obtained from the personal income tax and the declining share obtained from corporate income tax, shown in Table 4, as an unfair shifting of the tax burden from corporations to individuals. The fact that some large corporations reporting substantial profits have been able to reduce their taxable income to zero contributes to this perception.

Table 4
Structure of Government Tax Revenue in Canada, Selected Years, 1950–84
(percentage of total revenue)

	Personal income tax	Corporate income tax	Sales tax[a]	Payroll taxes[b]	Customs excise	Other
Federal government						
1950	22.0	30.5	22.3	4.2	17.8	3.2
1955	27.3	26.9	22.2	3.5	15.4	4.7
1960	32.0	22.8	22.8	4.6	14.6	3.2
1965	29.9	20.1	25.9	3.9	14.2	6.0
1970	45.0	16.2	19.0	3.5	9.8	6.5
1975	42.4	18.6	14.1	6.7	13.1	5.1
1980	42.4	19.0	13.7	6.9	13.2	4.8
1984	41.0	17.4	12.6	11.3	13.4	4.3
Total federal and provincial governments						
1950	17.1	27.7	19.7	3.8	13.8	17.9
1955	22.6	22.8	20.7	3.0	12.4	18.5
1960	25.1	20.1	19.5	5.0	11.1	19.2
1965	23.7	17.6	23.8	4.1	9.4	21.4
1970	36.4	12.7	19.1	9.6	5.7	16.5
1975	37.1	15.4	16.2	9.4	7.8	14.1
1980	38.7	14.7	15.5	9.6	7.2	14.3
1984	38.8	12.2	15.9	7.1	7.2	18.8

[a] Includes federal manufacturers' sales tax and provincial retail sales taxes.
[b] Includes unemployment insurance, and health, medical, and government pension premiums.

Source: Statistics Canada, *National Income and Expenditure Accounts*, Cat. no. 13–201, various issues.

It has also been argued that the present system is unfair to those who work hard and take risks because too much of the fruits of their labor is redistributed to others. It is virtually impossible to test these perceptions of fairness because they are primarily subjective. A more neutral tax system, however, with fewer exemptions and shelters and lower tax rates, may appear fairer to all.

The Tax Policy Agenda

Tax policy specialists share some of the popular concerns about the tax system, but their agenda is based more on issues relating to the design of an effective overall system that meets the federal government's revenue needs without creating unwanted distortions, inequities, or administrative costs. The tax policy agenda is driven both by the desire to achieve fundamental growth and distributional goals and by pragmatic concerns related to ensuring the smooth operation of the system. The most important objectives are:

• ***Reduce marginal personal tax rates.*** Even if the United States were not about to lower its marginal tax rates sharply, the increase in marginal rates in the personal tax system shown in Table 3 still would be a matter of concern. The steady upward creep in marginal tax rates since the 1960s has encouraged Canadians to alter their behavior in order to avoid paying tax. In the process, the incentive to make greater use of tax shelters and other legal tax-avoidance activities has increased. A greater proportion of economic activity goes unreported; the underground economy grows with little growth in government revenues. To meet revenue targets, federal and provincial governments have introduced surtaxes in recent budgets. These surtaxes further raise marginal tax rates, particularly those for middle- and upper-income individuals. Basic personal tax rates are well above the rates incorporated in the new U.S. tax law; the surtaxes further widen the gap.

• ***Improve integration of taxes and social transfers.*** In the February 1986 budget, the federal government announced its intention to reform Canada's system of social transfers and related tax provisions. The objective of the reform was to identify ways to maintain universal access to social programs, to direct more benefits to those most in need, to reduce the value of after-tax benefits going to higher-income individuals, and to encourage increased self-reliance.[5] The social programs under review fall into two categories: family benefits and elderly benefits. Each category contains a universal cash transfer component (family allowance and old age pension), an income-tested component (the child tax credit and the Guaranteed Income Supplement), and a tax deduction or exemption component (the dependent child deduction and the age deduction and pension income exemption).

One method of achieving the objectives of social program review is to reduce the levels of both the universal and the tax deduction/exemption components and use the savings to increase the income-tested components. This would maintain universal access, and shift the flow of after-tax benefits from higher- to lower-income individuals and families. Self-reliance could be encouraged and work incentives enhanced by redesigning the income-tested components so that benefits decline gradually but steadily as income from other sources increases.

• ***Reduce variability in effective corporate tax rates.*** Studies by the Department of Finance and the Economic Council of Canada note that different investment activities face large differences in effective tax

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[5]Hon. Michael H. Wilson, ***Budget Speech*** (Ottawa, February 1986), p. 12.

rates.[6] Marginal corporate tax rates vary across activities because the tax law offers different write-offs and provisions for specific forms of investment. The major sources of variability in marginal tax rates in recent years have included investment tax credits that apply to plant and equipment but not to land or inventories, accelerated depreciation allowances for manufacturing and processing but not for other industries, differences in federal statutory tax rates for large and small firms, and differences in provincial statutory tax rates for corporations operating in different provinces.

In 1985, the range of marginal tax rates across investments, industries, and provinces was immense. Investments in machinery carried marginal tax rates of nearly 40 percent for large firms in retail trade and commercial services, 14 percent for large firms in the resource industries, and an astonishing −5.7 percent for small manufacturing firms. (A negative marginal tax rate means that the value of deductions and tax credits is actually greater than the present value of the taxes that are eventually paid on the income from the project.) On a regional basis, combined federal and provincial marginal corporate tax rates are negative for agriculture, fishing, and forestry in Atlantic Canada, approximately 10 percent for manufacturing in Atlantic Canada, 21 percent for manufacturing in British Columbia, and as high as 35 percent for the transport industries in Manitoba and Saskatchewan.

An important focus of corporate tax reform has been to reduce the variability of marginal rates across activities. Less variation would produce less distortion in business investment decisions. In the longer term, it would encourage efficient allocation of capital, reduce obstacles to adjustment, and, thereby, strengthen economic growth.

The first stage of corporate tax reform, introduced in the February 1986 federal budget, will phase out the general investment tax credit and repeal the 3 percent inventory allowance, measures which are offset by a reduction in the corporate tax rate. These measures will go some distance toward equalizing corporate tax rates. The major causes of remaining marginal rate differences are the special investment tax credits applying to some regions of the country, the accelerated depreciation for manufacturing and processing, the lower small business tax rate, and the differences in corporate tax provisions across provinces.

• ***Reform the federal sales tax.*** The federal manufacturers' sales tax (MST) is widely agreed to be archaic, arbitrary, and inefficient.[7] It may be the

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[6]Department of Finance, ***The Corporate Income Tax System: A Direction for Change*** (Ottawa, May 1985), pp. 12–16; Economic Council of Canada, ***Changing Times: Twenty-Third Annual Review*** (Ottawa: Supply and Services Canada, 1986), pp. 30–33.

[7]See, for example, Malcolm Gillis, "Excising Excises: Federal Sales Tax Reform in Canada," in ***Report of Proceedings of the Thirty-Sixth Annual Tax Conference*** (Toronto: Canadian Tax Foundation, 1985), pp. 460–476.

only sales tax in the world that favors imports over domestically produced goods and that imposes a hidden tax on exports. Its many exemptions result in a narrow tax base with five commodities accounting for 64 percent of the revenue (the auto industry alone pays 29 percent of the tax). It is highly arbitrary, in that Revenue Canada is constantly forced to redefine the tax base to accommodate new types of distribution channels. Its administration is under constant pressure from taxpaying firms.

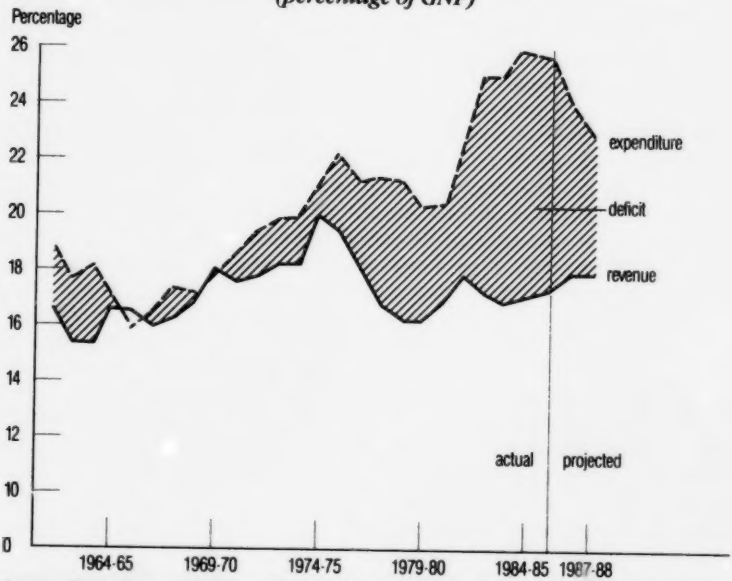
There have been a number of proposals to reform the MST over the years. One proposal was to move the tax to the wholesale level. Another was to replace the MST with a federal retail sales tax. Most recently, the Minister of Finance has indicated interest in replacing the MST with a business transfer tax (BTT), a variant of the value-added tax (VAT). A VAT, already in use in most European countries, is like a national sales tax that is levied at each stage of production on all goods and services. Under a "credit-method" VAT, businesses pay tax on their total sales and receive a credit for any VAT included in the cost of purchased inputs. A BTT is essentially the same as a VAT, the only difference being the precise method of calculating the tax. Under a BTT, businesses subtract the cost of all purchases from their total sales and apply the BTT rate to the difference.

The main difference between a VAT or BTT and the existing MST is that the former can be designed with a broader base, including most goods and services, and, therefore, can collect as much or more revenue than the MST with a much lower tax rate. Extending the sales tax to cover services would be a major departure from past practice; coverage of the federal sales tax would be extended not only to the wholesale and retail distribution sectors, but also to all types of personal and business services from haircuts to legal fees.

The Department of Finance estimated in 1985 that each percentage point of a broadly based VAT would generate $2.6 billion in revenue, meaning that the current 12 percent MST could be replaced with a VAT rate of about 4.5 percent. One major advantage of a BTT over a VAT is that a BTT is calculated periodically, say monthly or quarterly, rather than with every invoice. This would mean that paperwork and compliance costs of a BTT would be lower than for a VAT. The administrative ease of a BTT also would diminish the self-policing nature of the tax relative to that of a VAT.

Two major concerns remain about a BTT. The first is the potential conflict it could generate with the provinces, which are protective of their own sales tax base. The second is the so-called leviathan argument: because it is a potentially very big revenue raiser, a BTT could be used in future to expand federal spending and the role of government. In the end, the revenue-raising potential of a BTT may be its strongest asset; a BTT could be Canada's best hope for simultaneously achieving a lower personal income tax burden and continued progress in reducing the federal deficit.

Figure 5
Federal Government Revenue and Expenditure, fiscal years 1961-62–1987-88
(percentage of GNP)



Source: Department of Finance, *The Fiscal Plan* (Ottawa, February 1986), pp. 47, 119.

• ***Maintain or increase total tax revenue.*** It is significant that the Minister of Finance listed as the first fundamental objective of tax reform the need for the tax system "to provide sufficient revenues to finance government programs."[8] For over a decade, the tax system has not met this objective. While the deficit problem was caused largely by ballooning expenditure growth, the official view of the Department of Finance is that the discretionary tax cuts of the 1970s and early 1980s also played an important role.[9]

Figure 5 shows that from the early 1960s to the mid-1970s, federal expenditures and federal revenues relative to GNP followed an upward trend. During the second half of the 1970s, revenues declined sharply relative to GNP, for three reasons. First, the indexation of personal income tax brackets and exemptions removed the automatic tendency for revenues

[8]Wilson, Notes for Remarks, p. 2.
[9]Department of Finance, *The Federal Deficit in Perspective* (Ottawa, April 1983), pp. 39–54.

to grow faster than GNP. Second, the federal budget of 1974 contained sizable discretionary tax cuts, which the Department of Finance estimates cut revenues relative to GNP 3.4 percentage points by the end of the decade. Third, the transfer of additional tax points to the provinces as part of the 1977 Established Programs Financing arrangement further reduced federal revenues.

In the 1980s, efforts in the April 1983 and February 1984 budgets to stimulate the economy further eroded the federal revenue base. In the process, the elasticity of federal revenues relative to GNP growth was reduced.

It seems clear that if the federal government is unable to make further significant expenditure cuts, it will need a tax system that ensures that revenue growth keeps pace with the growth of the economy without having to resort to punitively high tax rates.

• *Integrate the federal and provincial tax systems.* In 1986, provincial governments are expected to collect about $70 billion in taxes, compared with $84 billion by the federal government. Provincial governments are active in all four major tax fields — personal, corporate, sales, and payroll — and their total tax collections increased to 75 percent of comparable federal collections in 1985 from only 13 percent in 1960. The increasingly important role of provincial taxes means that federal tax reform cannot be divorced from federal-provincial considerations.

Better integration of federal and provincial tax systems involves agreements between the two levels of government about tax bases, tax rates, tax collection, and administration. Currently, the federal government determines the tax base and collects personal income taxes for all provinces except Quebec, which has its own personal income tax. Three provinces — Quebec, Ontario, and Alberta — administer and collect their own corporate income tax; recent years have seen growing differences in the federal and provincial corporate tax systems, particularly in the area of tax incentives. Finally, federal and provincial sales taxes are quite separate, relying on totally different tax bases. A federal government decision to introduce a broadly based sales tax could require a federal-provincial agreement to integrate sales taxes by selecting a common tax base and sharing responsibilities for tax collection and administration.

Combining the Agendas

In the weeks following the U.S. tax reform breakthrough, Canadian analysts spent much time reflecting on the significance of the event for Canada. One editorial referred to the U.S. tax bill as "probably the prime achievement of Reaganomics," and argued that "the example of signifi-

cantly lower marginal tax rates for individuals in the United States is bound to attract the envy of many Canadians."[10] Most analysts felt that, under the circumstances, Canada has little choice but to get broadly in line with the United States. The prime minister seemed to encourage expectations that Canada would move in this direction when he pledged to implement "a simplified tax system resulting in a lower personal tax rate."[11]

Comparison of the populist and tax policy agendas outlined in the preceding sections suggests that while tax reform is badly needed in Canada, it should not be misconstrued as an easy route to a tax cut. A more realistic expectation is that tax reform, if successful, will enable Canadian governments to collect increased tax revenues through a system that is simpler, that has lower average and marginal rates, and that yields less distortion of economic activity and more equal treatment of taxpayers with similar incomes.

Three factors influence Canada's ability and need to reduce tax rates to the levels incorporated in the new U.S. tax law. First, because government spending as a percentage of GNP is higher in Canada than the United States, it is unrealistic to expect under present expenditure policies that Canadian tax burdens can fall to the level of those in the United States. Second, because Canada's personal and corporate tax systems were not as ridden with special provisions as were the old U.S. systems, there is less scope for base broadening in Canada to reduce tax rates. Third, the fact that Canadians may end up with higher tax burdens and rates is a matter of concern only to the extent that higher burdens are not offset by a higher level and quality of public services. Relying too heavily on this third factor, however, would be unwise. The benefits of public services cannot be measured by their cost, and subjective evaluations of the quality of these services vary widely among individual Canadians.

Past Canadian experience clearly indicates that strong lobbying by special-interest groups combined with unrealistic expectations may block potentially beneficial reforms of the tax system.[12] Avoiding this outcome will require those involved in tax reform to be prepared to resist pressures from special interests that do not promote the national interest and to be careful not to oversell what can be achieved.

What, in fact, can be achieved? In what follows, we describe four broad steps toward comprehensive tax reform that would achieve most, though not all, of the items on both the populist and the tax policy agendas.

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[10]"U.S. Tax Challenge," *Globe and Mail* (Toronto), August 20, 1986, p. A6.
[11]Rt. Hon. Brian Mulroney, Remarks, Vancouver, September 7, 1986.
[12]See Douglas Hartle, "Political Economy of Tax Reform: Six Case Studies," Discussion Paper no. 290 (Ottawa: Economic Council of Canada, November 1985); and W. Irwin Gillespie, "The 1981 Federal Budget: Muddling Through or Personal Tax Reform?" *Canadian Tax Journal* 31 (November–December 1983): 975–1002.

Step 1: Introduce a Business Transfer Tax

A BTT is the key to comprehensive tax reform in Canada. Only a shift of some of the overall burden from personal income tax to a sales tax will bring federal personal tax rates in line with those in the United States. To achieve this shift, it would be necessary to define the base of a BTT broadly and to apply a rate that is sufficient not only to replace the MST but also to allow personal surtaxes to be removed and the sales tax credit to be enhanced to offset the impact on low-income taxpayers. In fiscal year 1986–87, this would mean that a BTT would have to generate approximately $12 billion plus the cost of the sales tax credit. Based on Department of Finance estimates of the yield of a broadly based consumption tax, this implies that a minimum BTT rate would be about 5 percent. Setting a higher rate would provide greater room for lower income tax rates or for greater deficit reduction. A BTT, like a VAT, is, however, built into final selling prices. Thus, the higher the BTT rate, the larger would be the increase in the prices of goods and services to consumers.

Introduction of a BTT would raise some thorny technical and transitional problems. While the taxation of most goods presents no major problem, taxation of services is more difficult. Many services, such as postsecondary education, health, and family services, are provided by government or by nonprofit organizations, and questions would arise as to whether they should be subject to a BTT. Another difficult area is financial services. If these were taxed, individuals, pension funds, and corporate financial managers would face increased transaction costs for managing investment portfolios. To avoid opening the door to a long list of exemptions, however, a BTT should be as broadly based as is practical.

The importance of keeping a BTT simple — covering as wide a range of goods and services as is practical with a single tax rate — cannot be overstated. Many European countries have allowed their VATs to increase in complexity with many exemptions and multiple rates. If Canada were to adopt this approach, the end result could be the replacement of one arbitrary, distortionary sales tax with another.

Step 2: Complete Corporate Tax Reform

In order to bring Canada's corporate tax rate in line with that of the United States, the federal government will have to continue to broaden the corporate tax base along the lines proposed in the May 1985 budget. Completing this reform will mean phasing out the special accelerated depreciation and lower tax rate for manufacturing and processing industries. Broadening the corporate tax base will end the huge build-up of unused tax deductions that has occurred in recent years.

A broader tax base also will permit further lowering of the corporate tax rate. The first phase of corporate tax reform lowered the basic federal cor-

porate tax rate to 33 percent from 36 percent. Provincial corporate tax rates add another 10 to 16 percent on average. In the United States, reform of the corporate tax will reduce the federal tax rate to 34 from 46 percent, yet the overall corporate tax burden is still expected to increase by U.S.$120 billion over five years. State corporate tax rates vary tremendously, but they average approximately 5 percent. There will be pressure to bring Canada's combined federal-provincial corporate tax rate down to the new U.S. level. The Department of Finance estimates that broadening the corporate tax base potentially would allow a basic federal corporate tax rate of 29 percent.[13] Setting the federal rate at 29 percent and phasing out the corporate surtax of 3 percent that was put in place in February 1986 to aid deficit reduction could permit a combined corporate tax revenue rate that is broadly competitive with the new U.S. law.

Completing corporate tax reform will raise some difficult issues. First, moving away from existing accelerated depreciation schedules will require careful attention to the treatment of depreciation in the U.S. corporate tax reform. In the U.S. reform, depreciation allowances on machinery and equipment were not reduced significantly. Given the importance of maintaining a tax system that encourages the adoption of new technologies and modern equipment, it would be unwise to treat depreciation of machinery and equipment less favorably in Canada than in the United States. Second, choosing a new structure for corporate tax rates will require careful consideration. Under the current system, there are four rates of federal corporate tax: 13 percent for small nonmanufacturing businesses 33 percent for large nonmanufacturing businesses, 8 percent for small manufacturers, and 26 percent for large manufacturers. The new U.S. tax law contains three corporate tax rates: 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000 of taxable income, and 34 percent on taxable income above $75,000.[14] The Business Council on National Issues has called for a combined federal-provincial corporate tax rate of 35 percent for all firms regardless of their size or industrial sector, on the grounds that all corporations should be treated the same.[15] In the past, the rationale for lower tax rates for small firms has been that they invest less in machinery and equipment and consequently are less able to take advantage of accelerated depreciation and investment tax credits. The degree to which this rationale remains valid will need to be assessed.

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[13]Department of Finance, *The Corporate Income Tax System*, p. 31.
[14]*The Price Waterhouse Guide to the New Tax Law* (Toronto: Bantam, 1986), p. 142.
[15]Business Council on National Issues, *Taxation Policy Reform and the National Agenda* (Ottawa, October 1986), p. 15.

Step 3: Reform the Personal Tax and Transfer System

Canada's personal tax system has not been as badly eroded by exemptions, deductions, and write-offs as had the U.S. system. Canada's relatively broader personal tax base has allowed lower federal marginal tax rates than in the United States, particularly since the rate reductions introduced in the November 1981 federal budget. This does not mean, however, that there is no scope for broadening Canada's personal income tax base and further lowering rates. It simply means that existing deductions, exemptions, and credits have been retained because the political and economic arguments in their favor so far have outweighed arguments for broadening the tax base.

There are three major categories of personal income tax provisions that provide scope for broadening the tax base: family tax benefits, elderly tax benefits, and the tax treatment of investment income and capital gains. The first two are presently the focus of the federal government's commitment to reform Canada's system of social programs. Thus, the reform of the personal tax system and the social program review are inextricably intertwined.

We see reform of the personal tax system as having four elements. The first is reform of the family benefits system. Based on the earlier discussion in this chapter, a reform of family benefits that meets the principles set out by the Minister of Finance could involve several changes. First, retaining the family allowance at a reduced level combined with an identical reduction in the dependent child deduction would ensure the universality of family benefits and reduce after-tax benefits for high-income families. Second, an increased child tax credit that phases out beginning at a lower family income but at a more gradual rate than in the present system would target more family benefits to low-income families. Third, converting the spousal deduction to a tax credit would provide the same tax benefit regardless of family income and reduce the disincentive the existing deduction now creates for spouses to return to work. A reform of family benefits along these lines would target them to low-income Canadians yet encourage greater self-reliance and provide some broadening of the personal income tax base.

The second element in personal tax reform is to rearrange the elderly benefits system. This could involve several changes. First, retaining the universal Old Age Pension (OAS) at current levels and increasing the income-tested Guaranteed Income Supplement (GIS) over time would preserve universality yet provide more benefits to low-income pensioners. Second, phasing out the age deduction and the pension income exemption and using the savings to increase OAS/GIS, or converting the deduction and exemption to tax credits, would reduce the after-tax benefits for the high-income elderly. These changes, like those described above for family benefits, could meet the objectives of social program reform and provide some broadening of the personal income tax base.

The third element in the process is to re-examine investment incentives in the personal tax system. A provision of the May 1985 federal budget allowed every Canadian a capital gains exemption of $500,000 over his or her lifetime. Within months of the announcement, tax advisors were urging clients to take advantage of the exemption as soon as possible since it was viewed as unlikely to remain a permanent feature of the tax system. This expectation has two negative consequences. First, it encourages individuals to undertake paper transactions to convert other types of investment income, such as interest and dividends, into capital gains to take advantage of the exemption. At the same time, the expectation reduces the encouragement to entrepreneurial activity and equity investment that was the original rationale for the exemption.

With the rationale for the exemption eroded and with the United States' having decided to tax capital gains fully, the lifetime capital gains exemption has become a candidate for base broadening. Furthermore, tax reform that generates a more neutral tax system with lower personal tax rates would reduce the need for a $500,000 capital gains exemption.

Another candidate for base broadening is the $1,000 exemption for interest and dividend income. This exemption was introduced in the mid-1970s as an *ad hoc* measure to protect interest and dividend income from inflation. With the recent decline in inflation and the desire to reduce personal tax rates, the exemption could now be ended. Because older Canadians who have accumulated savings over their lifetimes are major beneficiaries of the exemption, some of the increased tax revenue that its elimination would generate could be used to augment elderly benefits programs.

The fourth and final element of personal income tax reform is to redesign the level and structure of tax rates. The degree to which personal tax rates can be reduced will depend not only on the personal income tax base broadening generated by reform of family and elderly benefits and the treatment of capital gains and investment income, but also on the extent to which increased revenues are generated from the federal sales and corporate tax systems. Only when agreement is reached on these matters will the dust settle sufficiently to determine the scope for the personal tax rate reduction to which the prime minister alluded. It is this realization that underscores the wisdom and necessity of the government's July 1986 annoucement of its intention to undertake comprehensive tax reform. Continuing the previous strategy of independent, revenue-neutral reform of the sales and corporate taxes would have limited severely the potential for reductions in personal tax rates.

Once the scope for personal tax rate reductions is clarified, the issue of the structure of rates will emerge. The present system contains 10 tax brackets, with marginal rates ranging from 6 to 34 percent. The new U.S.

system, which contains only two rates — 15 and 28 percent — raises the question of whether Canadians will want to give up the smoother progression of tax rates that characterizes the current tax system in order to reduce the number of tax brackets. Although reducing the number of brackets seems to be a popular idea, it has a major disadvantage: it creates sharp increases in marginal tax rates at certain income levels. A larger number of tax brackets, with a smoother progression of tax rates, would create fewer incentives for taxpayers to avoid moving into a higher-income bracket.

Step 4: Coordinate Federal Tax Changes with the Provinces

Provincial governments have an immense stake in tax reform. A federal government decision to shift the tax burden from personal income tax to a business transfer tax, for example, would reduce provincial income tax revenues and increase the federal presence in the sales tax field. A federal decision to broaden the corporate tax base further and to lower rates would widen differences with those provinces that administer their own corporate tax systems. In these circumstances, it is essential that federal tax reform is coordinated with the provinces. There are many ways to do this. One way is to negotiate a new Tax Collection Agreement over the sales tax field, using a common but broader tax base (as in the BTT), a basic federal tax rate, and separate tax rates set by each province as a replacement for their retail sales taxes. Another option is for the federal government to move out of the sales tax field altogether in return for a provincial agreement to vacate the corporate tax field.

The provinces also have an important responsibility for reform of the system simply by virtue of their large share of total taxes. While the federal government has to take the lead, it cannot carry out a successful reform without the participation of the provinces. Ultimately, the provinces will make or break tax reform. They can make it if they seek constructive ways to reduce their own significant contribution to high marginal tax rates and to the variability of corporate taxation across provinces. They can break it if they seek to occupy tax room vacated by the federal government or if they oppose broadening of the federal sales tax base.

Focusing the Debate

The four-step process for comprehensive tax reform spelled out above provides a general approach that blends the objectives of the populists and those of the tax policy specialists. It represents an evolution of ideas for reform of individual components of the federal tax system that have been germinating for several years. As such, it is not a radical change in direction. It is also clearly not a panacea for reducing the overall federal

tax burden. Rather, it is a shifting and leveling out of the tax burden among individuals and across economic activities. As in the case of U.S. tax reform, some individuals and corporations will pay more and others will pay less. Seen in this light, there are three important issues on which the Canadian tax reform debate should focus.

• *What is the appropriate mix of sales and income taxes for Canada?* Is there an economic rationale that supports increases in sales and corporate taxes in order to achieve lower personal income tax burdens? As economist Jonathan Kesselman of the University of British Columbia has recently pointed out, there are valid arguments both for and against shifting the tax mix.[16] The most powerful arguments against a major shift toward sales taxes include the immediate impact of increasing final selling prices of goods and services, which would show up as a temporary increase in inflation, and the "leviathan" argument that adoption of a broadly based sales tax might be used in future to fuel the growth of government. The strongest argument in favor of a shift toward more emphasis on sales taxes is that the increased revenue would greatly lubricate the process of reforming the personal income tax and reducing personal tax rates.

• *How will the distribution of the tax burden across income groups be altered?* If the federal government does decide to move to reform personal, corporate, and sales taxes simultaneously, a complex redistribution of the overall tax burden will occur. Debate over the reforms will bog down if it focuses on which groups will pay more and which less as a result of individual tax changes. To avoid this outcome, it will be important for tax policy analysts, both inside and outside of government, to estimate how the distribution of the tax burden across income classes will be altered by proposed reform *packages*, not just specific tax or transfer changes.

• *What will be the timing and transitional arrangements?* No matter what shape tax and transfer reform takes, the importance of the need for consultation on the timing of tax changes and the design of transitional arrangements cannot be understated. The November 1981 tax reform experience provides the clearest evidence that failure to provide sufficient time to adapt to tax changes can generate strong political resistance to any change. Difficult transitional problems and large capital losses can

[16]Jonathan Kesselman, "The Canadian BTT, the Tax Mix and Tax Reform" (Presentation to the Policy Forum on the Business Transfer Tax, 1986 John Deutsch Institute for the Study of Economic Policy, Queen's University, Kingston, Ontario, August 15, 1986).

be reduced by providing grandfathering provisions where necessary and by phasing in the tax changes over a reasonable period of time. The U.S. tax reform bill does not appear to have given much consideration to managing the transition, and the result could be a pause in both investment and consumer spending in the United States as taxpayers get used to the new rules.

Managing the transition to a simpler, more effective tax system will test the capacity of Canada's policymaking process. Douglas Hartle of the University of Toronto has observed that, historically, tax reform debate in Canada has been conducted behind closed doors and that resulting tax policies "almost invariably reflect a compromise negotiated in private" between government and special-interest lobbies.[17]

Public debate on tax reform is important, but past experience in Canada and elsewhere indicates that it can also be a recipe for paralysis. Fifteen years of public debate on reform of the manufacturers' sales tax has yet to generate consensus. In the recent U.S. tax reform experience, public debate amounted to little more than special-interest lobbying. In the end, it was the leadership of a small group of individuals, rather than exhaustive public debate, that won the day for tax reform in the United States.

The lesson for Canadian policymakers is that successful tax reform will require a vision of a tax system suited to Canadian circumstances, a clear timetable for implementation complete with transitional arrangements, and a well-defined process for consultation with provincial governments and the private sector on issues that require cooperative solutions. If the federal government can provide these elements, along with the leadership and political will to see the process through, comprehensive tax reform, which has eluded Canada for 20 years, will be within reach in 1987.

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[17]Hartle, "Political Economy of Tax Reform."

3

Challenges from the Global Economy

> *"We are taking enormous risks. We have been taking them too long."* — Paul Volcker, Chairman, U.S. Federal Reserve Board, September 1986.

Global economic interdependence is such a fact of life that the prospects for an open economy such as Canada cannot be discussed without taking careful account of world economic developments. The importance of Canada's links to the world economy looms especially large as Canadians look ahead to 1987. The persistent global economic imbalances that emerged after the 1981–82 recession pose a potentially serious risk to the world economy. The outcome of efforts by the large industrial economies to reduce these imbalances will become increasingly clear in 1987 and will have profound implications for world economic growth and the health of the world trading system. Canada's interest in the outcome is great; its ability to sustain economic growth and to penetrate world markets hangs in the balance.

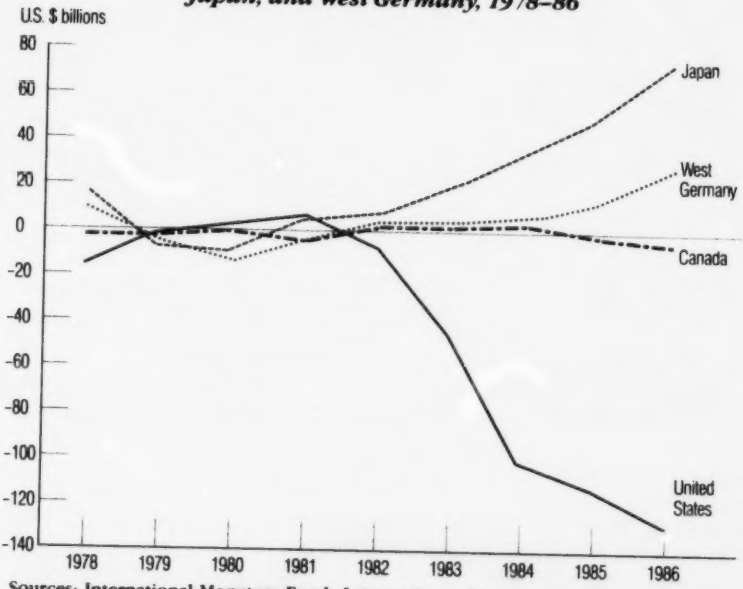
Canada competes in global markets and participates in international economic institutions as a small but potentially influential actor. But Canadians still do not have a clear understanding of how events abroad dominate any realistic evaluation of Canada's economic prospects for 1987. Two developments stand out: poor coordination of macroeconomic policies among the large industrial countries, and an ominous trend toward protectionism and managed trade.

This chapter examines the challenges these two developments pose for the world economy. The first challenge is to reduce enormous current account imbalances. Failure to meet this challenge could mean further escalation of international trade frictions, economic stagnation, and worsening debt problems. The second is to restore the principles underlying a liberalized world trading system. Failure to meet this challenge risks a spiral of "beggar-thy-neighbor" trade and exchange-rate policies and a further damaging spread of managed trade.

The Macroeconomic Challenge

Economic growth is the single most potent antidote to the ills and imbalances of the world economy. Depressed commodity prices, debt problems in developing countries, double-digit unemployment in Europe, and the budgetary and current account imbalances of the industrial countries

Figure 6
Current Account Balances for North America, Japan, and West Germany, 1978–86



Sources: International Monetary Fund, *International Financial Statistics*, online data base series; *OECD Economic Outlook* (Paris, May 1986), p. 58.

are all problems that will worsen if economic growth falters. While all countries recognize this, no single one is in a position to adopt policies to ensure that the world economic expansion is sustained for several more years. Thus, the world macroeconomic challenge is to develop sufficient coordination among the fiscal and monetary policies of the major countries of the Organisation for Economic Co-operation and Development (OECD) to reduce economic imbalances without bringing about a recession in the process.

Current Account Imbalances

The large trade and current account imbalances among the major industrial countries are the focus of international macroeconomic policy concern. From late 1982 until early 1985, the strength of the U.S. economic recovery and of the U.S. dollar on foreign-exchange markets resulted in a growing current account deficit in the United States and growing current account surpluses in Japan and West Germany, as shown in Figure 6.

Table 5
Components of the U.S. Current Account Balance, 1980 and 1985
(U.S. $ billions)

	1980	1985
Exports	224.2	214.5
Imports	-249.7	-338.9
Merchandise balance	*-25.5*	*-124.4*
Net investment income	30.4	25.2
Other services	4.6	-3.4
Services balance	*35.0*	*21.8*
Other transactions	*-7.6*	*-15.0*
Current account balance	*1.9*	*-117.7*

Source: *Economic Indicators* (U.S. Council of Economic Advisers), June 1986.

Since 1980, when it had a small surplus, the United States has experienced an uninterrupted worsening of its current account balance. The deficit that emerged in 1982 grew to U.S.$118 billion in 1985 and could reach $150 billion in 1986.

As shown in Table 5, several individual components have contributed to the deterioration of the overall U.S. current account. The most important of these has been the merchandise trade deficit, which increased by approximately $100 billion from 1980 to 1985, primarily because of rapid U.S. economic growth and the strength of the U.S. dollar over most of that period. Yet, in spite of the sharp depreciation of the U.S. dollar that began in 1985 and the slowdown in U.S. growth in 1986, the trade deficit has continued to widen. Other major components of the current account balance have deteriorated as well. The surplus of investment income has diminished as large capital inflows have transformed the United States from the world's largest net creditor in 1980 to the largest net debtor in 1986. Because it will take years to eliminate the U.S. current account deficit, sizable capital inflows will be required for some time to come, meaning that the investment income balance will deteriorate further. Even in other categories of the current account — nonfinancial service transactions and other remittances and transfers — the deficit has widened appreciably.

The deterioration of the U.S. investment position abroad means that the overall U.S. current account is likely to improve only through a significant turnaround in the balances on merchandise and nonfinancial services. Table 6 shows the composition of the U.S. merchandise trade balance by region. Significantly, the United States has experienced a growing trade deficit with virtually all of its important trading partners with the exception of the oil-exporting countries of the Middle East.

Table 6
U.S. Merchandise Trade Balance by Trading Partner, 1984 and 1985
(U.S. $ billions)

	1984	1985
Japan	−37.0	−43.4
Other Asia	−25.4	−25.7
Europe	−15.2	−21.2
Canada	−16.1	−17.1
Latin America	−18.6	−15.6
Other	−1.8	−0.3
Total	*−114.1*	*−123.3*

Source: Bank for International Settlements, *Fifty-Sixth Annual Report* (Basle, June 1986), p. 41.

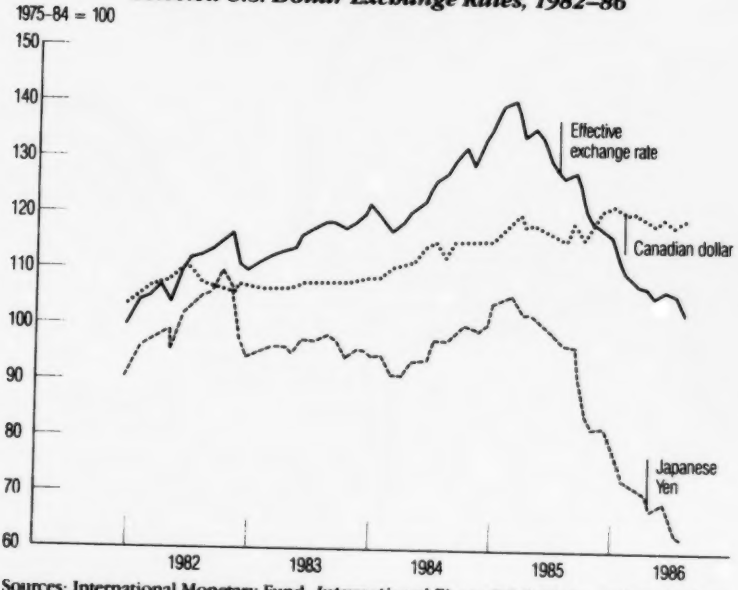
The growing U.S. trade deficit has been associated with a sharp rise in protectionist pressures. Under mounting pressure from industry and Congress, the Reagan administration has adopted an aggressive approach to attempt to force trading partners to open their domestic markets to U.S. goods, to avoid sharp increases in exports to the United States, and to respect U.S. fair trade principles. The United States not only demands a "level playing field" in international trade, but also insists on acting as a referee with the right to change the rules whenever the home team gets behind in the score. While protectionist practices are not limited to the United States, recent developments are ominous for Canada and for the entire world trading system.

The Role of Exchange Rates

In part, the widening U.S. current account deficit is a response to the appreciation of the U.S. dollar relative to other world currencies between 1980 and early 1985. The turnaround of the U.S. dollar from its February 1985 peak, shown in Figure 7, reflects several important developments: U.S. monetary policy was eased, the rapid pace of U.S. expansion slowed, and the speculative bubble in foreign-exchange markets of early 1985 burst because of coordinated central bank intervention. The U.S. dollar, having overshot most realistic estimates of its appropriate value, depreciated steadily between March and August 1985.

In spite of this significant depreciation, the current account imbalance and protectionist pressures increased significantly. To forestall Congress passing potentially disastrous legislation to curb U.S. imports, the Reagan administration used a meeting of finance ministers and central bank

Figure 7
Selected U.S. Dollar Exchange Rates, 1982–86



Sources: International Monetary Fund, *International Financial Statistics*, online data base series; *Bank of Canada Review*, various issues.

governors of the Group-of-Five (G-5) countries in September 1985 to announce an important reversal in U.S. policy and to support coordinated intervention in foreign-exchange markets to bring about further depreciation of the U.S. dollar. In the Plaza Agreement, named for the New York hotel where the meeting was convened, the G-5 countries committed to improve the coordination of their fiscal and monetary policies. Specifically, this meant that the United States would take steps to cut its large budget deficit, while Japan and West Germany would take steps to increase domestic demand. Better macroeconomic policy coordination was seen as essential to creating a new alignment of exchange rates that would reduce current account imbalances.

The Plaza Agreement caused a fundamental change in perception among participants in foreign-exchange markets about the level of the U.S. dollar deemed appropriate by the U.S. government. In the year following the agreement, the dollar declined by a further 36 percent against the Japanese yen and 29 percent against the West German mark. Yet while

the dollar depreciated massively against the currencies of Japan and Europe, it remained strong against those of other countries — such as Canada, South Korea, and Taiwan — that together account for over half of total U.S. trade.

By mid-1986, a strong consensus developed in West Germany and Japan that the realignment of major currencies had gone far enough. Authorities in these countries deemed further coordinated efforts to reduce the value of the U.S. dollar as neither necessary nor useful. Pressures created by the depreciation of the dollar on the profitability of their export- and import-competing industries were already evident. Nevertheless, even with a further moderate depreciation of the dollar, current account imbalances were expected to persist unless stronger growth in domestic demand materialized in Europe and Japan. The United States took the position that if its major trading partners wished to avoid further declines in the dollar, they would have to adopt policies to boost domestic demand.

As U.S. economic growth slowed in 1986, pressures increased for coordinated cuts in interest rates. Europe and Japan matched U.S. rate cuts in early 1986. But as their domestic interest rates fell to historically low levels, they resisted further coordinated reductions at mid-year. The result was two unilateral cuts in the U.S. discount rate, which sent the U.S. dollar down relative to European currencies and to an all-time low in September 1986 of 153 Japanese yen to the dollar. A year after the Plaza Agreement, the dollar had dropped further and faster than anyone at the G-5 meeting had anticipated. Yet the rapid realignment created new problems. At the September 1986 G-5 meeting, the United States, West Germany, and Japan openly disagreed about the appropriate conduct and coordination of policy.

The United States also stepped up pressure on Canada and some of the newly industrializing countries to abandon policies that it insisted were holding their currencies down against the U.S. dollar. Canada inadvertently increased its exposure to these pressures when, after being excluded from the G-5 meeting in September 1985, it successfully lobbied for inclusion (along with Italy) in an expanded Group-of-Seven (G-7) countries. Immediately on agreeing to expand the group, the U.S. Treasury Secretary pointed to Canada's responsibility to manage its exchange rate to help cut the U.S. trade deficit.

By the autumn of 1986, there were signs that the U.S. trade deficit was finally about to turn around. The slow response of the deficit to the drop of the U.S. dollar was ascribed by most economists to the well-known "J-curve" effect. After a depreciation, import prices tend to increase right away in dollar terms, thus boosting both the deficit and the value of imports. As time passes, the increased price of foreign goods in the United States and the decreased price of U.S. goods abroad brings about a decrease

in import volumes and an increase in export volumes. Eventually, the negative short-term price effect is overcome by the positive effect on trade volumes, and the deficit is reduced. Econometric estimates for the United States suggest that it takes 12 to 18 months for the positive effects to dominate.[1]

What has surprised many analysts is the size of the increase in the trade deficit since the dollar began depreciating in early 1985 and the slowness of the positive effects on trade volumes to emerge. There are several possible explanations for these surprises. First, because of normal lags, the rising volume of U.S. imports may still be a reflection of the dollar's appreciation from 1980 to 1985. Second, the initial response of foreign exporters to the dollar depreciation has been to reduce their profit margins on U.S. sales, rather than to increase their prices, so that there is little incentive for U.S. consumers to purchase fewer imports. Third, during the period when the dollar was strong, many U.S. manufacturers began investing in production facilities abroad, which continued to ship to the United States after the dollar depreciated. Fourth, voluntary restraints on exports of Japanese automobiles to the United States were relaxed in 1986, allowing a significant increase in U.S. automobile imports. Fifth, the effects of the depreciation on the price of imports relative to U.S. products simply may not yet be strong enough, in part because U.S. producers have used the room provided by the depreciation to increase their own prices.

Most economists maintain that the trade deficit is beginning to show signs of improvement, which will continue in 1987. Without a substantial pickup in demand in Europe, Japan, and other major U.S. trading partners, however, the improvement may be too little and too late to reverse the rising tide of U.S. protectionism in 1987.

Savings and Investment Imbalances

The relationship between the current account and fiscal imbalances in the industrial countries is best analyzed within the context of the overall balance between savings and investment within each country.[2] In short, a country's savings-investment balance must change if its current account balance is to change.

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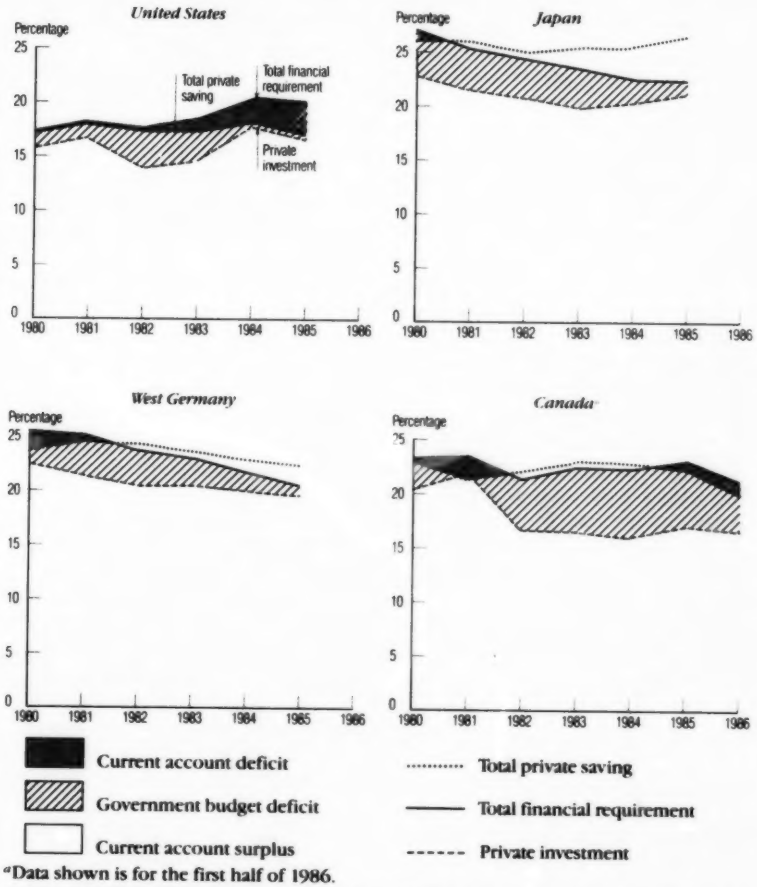
[1]See, for example, Robert Z. Lawrence, "An Analysis of the 1977 U.S. Trade Deficit," *Brookings Papers on Economic Activity* (1978:1): 173–179.

[2]The argument that domestic savings-investment imbalances underlie current account imbalances is not a new one. For a useful development of the idea, see John Williamson, *The Open Economy and the World Economy* (New York: Basic Books, 1983), pp. 131–133, 160–175. Recently, the relationship has been emphasized by C. Fred Bergsten and William R. Cline, *The United States-Japan Economic Problem* (Washington: Institute for International Economics, 1985); and Masaru Yoshitomi, *Japan as Capital Exporter and the World Economy* (New York: Group of Thirty, 1985).

Figure 8
Savings-Investment Balances in Major Countries, 1980–85
(percentage of GNP)



[a]Data shown is for the first half of 1986.

Source: C.D. Howe Institute, based on data from *OECD Economic Outlook* (Paris, May 1986), and Statistics Canada.

The divergent trends in investment demand relative to domestic savings in the United States, Japan, West Germany, and Canada are shown in Figure 8. For each country, the total financing requirement or the total demand for savings is equal to the sum of private investment and the government budget deficit. In the United States, the coincident rise in private investment and the government budget deficit after 1982 created a serious domestic financing shortfall. Foreign savings flowed into the United States to take advantage of relatively high real interest rates and the expectation of further appreciation of the U.S. dollar. The higher exchange rate put upward pressure on the price of U.S. exports and made many imports less expensive in the United States, thereby pushing up the current account deficit. The capital inflow and counterpart current account deficit amounted to 3.0 percent of U.S. GNP in 1985.

Japan and West Germany have exhibited just the opposite trends. In both countries, private investment diminished at the same time that the government sector cut its budget deficit. In Japan, private savings increased after 1982, the capital outflow and current account surplus grew to 3.5 percent of GNP by 1985. In West Germany, financing requirements for private investment and government deficits fell by more than private savings, producing a capital outflow and current account surplus equal to 2.5 percent of GNP in 1985.

Canada's savings-investment balance has evolved differently. The sharp increase in the deficit in 1982 was matched by an even larger decrease in private investment. The drop in private investment and a slight rise in savings turned Canada's capital inflows and current account deficit of 1980–81 into capital outflows and a current account surplus from 1982 through 1984. As private investment picked up and private savings diminished in 1985 and 1986, the current account returned to deficit. Canada's large budget deficit did not require foreign capital inflows during the 1982–84 period because it coincided with a sharp decline in private investment. Developments in the past two years show that persistent large budget deficits combined with stronger private investment now have created a counterpart current account deficit.

Figure 8 clearly illustrates that the current account imbalances of the major industrial countries are rooted in domestic savings-investment imbalances, which themselves are closely related to the divergent government fiscal policies. Thus, deficit cuts in West Germany and Japan since 1980 are as much a cause of current account imbalances as is fiscal excess in the United States. Just as these divergent fiscal policies played a major role in creating trade imbalances, they can also play an important role in turning the situation around.

Restoring Balance

If the objective was simply to eliminate the U.S. current account deficit, it would matter little whether the budget deficit or private investment is cut. Which of these routes is taken, however, matters a great deal to U.S. economic growth. If a steady, managed reduction in the budget deficit can be achieved, there is a chance that the U.S. trade deficit can decline without a recession. Failure to achieve deficit reduction, however, risks reducing the trade deficit through a loss of confidence in U.S. economic policy, a drop in private investment, and recession.

While there are many ways in which balance could be restored, two are worth examining in some detail. The first is the international cooperative solution endorsed at the G-5 meeting in September 1985 and again at the Tokyo Economic Summit in May 1986. The second is an illustrative, noncooperative outcome.

The international cooperative solution has three main elements: U.S. deficit reduction, U.S. dollar depreciation, and stronger expansion of domestic demand in Japan and Europe. A large U.S. dollar depreciation has already taken place. But the more fundamental changes in fiscal and monetary policies remain to be carried out. If they are undertaken in 1987, it is possible that savings and investment will come into balance at a relatively high level, accompanied by healthy economic growth in all of the large industrial countries. This outcome would clearly be best for the industrial countries, and Canada would be a major beneficiary. Stronger performance among Canada's trading partners would support growth, improve the prospects for a significant reduction in Canada's budget deficit, and spur private investment.

The major industrial countries have not made much progress in moving toward the cooperative outcome. In the United States, part of the Gramm-Rudman act was declared unconstitutional, creating uncertainty as to whether automatic budget cutting would occur. In the absence of significant deficit reduction in the United States, West Germany and Japan have resisted U.S. pressures to stimulate domestic demand.

This leaves the possibility that the trade imbalances will be corrected without coordinated policy changes. Governments of the industrial countries have "talked down" the U.S. dollar, instead of carrying out, as agreed, the fundamental changes in macroeconomic policy that would create a viable international equilibrium. In an environment of a much lower U.S. dollar and little or no reduction in the U.S. budget deficit, the U.S. economy is increasingly at the mercy of other countries' willingness to absorb U.S. government debt. A loss of confidence in the ability of U.S. policymakers to cope with budget and trade imbalances could quickly force U.S. real interest rates higher and weaken interest-sensitive demand.

Neither Japan nor West Germany, however, is without options for increasing domestic demand in the event that U.S. economic growth slows. Clearly, there are risks on both sides, as West Germany's Finance Minister has pointed out:

> An artificial stimulation of demand, using fiscal and monetary policies as a lever for stronger international economic revival, would simply preprogram the next inflationary wave and after that the next crisis of stability.[3]

Assessing the probability of various outcomes — policy coordination, U.S. recession, or some form of muddling through — is fraught with uncertainty. The message for Canadian macroeconomic policy in 1987 is that a pragmatic and flexible domestic approach is essential. In the event that the United States does meet Gramm-Rudman targets and that growth in Europe and Japan improves, the environment will be right for Canada to accelerate the reduction of its government deficit and provide room for stronger growth of private investment. In the event of a breakdown in U.S. resolve and inertia in Europe and Japan, Canada, with its already weak private investment and large budget deficit, will be extremely vulnerable. A further run-up in the budget deficit then could be unavoidable and much pressure would be placed on monetary policy to limit the forces of recession. (In Chapter 4, we return to the issue of appropriate Canadian macroeconomic policies.) The possibility that the United States, Japan, and Europe will not arrive at a cooperative solution means that savings-investment imbalances and accompanying current account imbalances may not be corrected in 1987. In that event, protectionist sentiment is likely to remain high and pose a second major challenge to the world economy.

The Challenge of Managed Trade

Nineteen eighty-six has not been a good year for the world trading system. Pressures generated by the large U.S. trade deficit and the competitive prowess of the newly industrializing countries (NICs) have eroded the liberal principles of world trade enshrined in the General Agreement on Tariffs and Trade (GATT). In its most recent annual report, the GATT Secretariat itself notes the "increasing difficulty not only in furthering trade liberalization but also in safeguarding previously negotiated levels of market access."[4] A less guarded depiction of the situation is that of world trade law specialists Gerard and Victoria Curzon:

> [The GATT] is now incapable of halting daily violations of its most innocuous rules, let alone defend its basic principles. Evidence of the breakdown is everywhere. . . [A]n undeclared trade war is in progress.[5]

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[3]Peter Bruce, "Bonn attacks U.S. over rate cut pressure," *Financial Times* (London), September 10, 1986, p. 1.
[4]*GATT Focus*, no. 40, July–August–September, 1986, p. 5.
[5]Gerard Curzon and Victoria Curzon, "Defusing Conflict between Traders and Non-Traders," *The World Economy* 9 (March 1986): 20.

The rise of protectionism associated with large trade imbalances is partly to blame for the breakdown of the GATT system. But the underlying source of this breakdown is unwillingness of individual member countries of the GATT to adjust to changes in international comparative advantage. While some countries remain open traders, lapses into protectionism are spreading. All GATT members have trade barriers and industrial policies that significantly slow or block adjustment to shifting comparative advantage. GATT rules permit countries experiencing severe economic injury from imports to adopt temporary safeguard measures involving tariffs or quotas. But major trading areas such as the United States, the European Community (EC), Japan, and Canada increasingly prefer to sidestep GATT rules that require trade policies to be nondiscriminatory and clearly visible. Instead, they deal with adjustment problems through discriminatory, nontransparent forms of protection such as voluntary export restraints (VERs) and market-sharing agreements.

This increasing reliance on policies that are inconsistent with GATT principles leads many observers to conclude that the international system is drifting steadily toward one in which trade is "managed" by governments, rather than based on international comparative advantage. Under managed trade, government negotiations determine trade flows. In its strongest form, managed trade involves negotiated market shares for imports. In its weaker forms, it involves local content requirements, negotiated terms of access for imports, and direct government intervention to influence the prices of traded goods.

The spread of managed trade is an ominous development for Canada because, within managed sectors, trade is determined more by political clout than by comparative advantage. A country's bargaining power in a managed trade sector is directly related to the size of its domestic market. Thus, the terms of managed trade agreements are set by the United States, Japan, and the EC, with their large, high-income markets, not by smaller countries such as Canada. As the world moves toward managed trade, Canada is caught in a squeeze play. On the one side, manufactured goods from the NICs threaten to reduce the market share of domestic manufacturers. On the other side, Canadian exporters in sectors where Canada does demonstrate comparative advantage are finding that their access to traditional markets is threatened.

Canada increasingly is being drawn into managed trade arrangements. In traditionally protected sectors such as textiles and clothing, Canada has participated in the further tightening of market access by industrial countries. In agriculture, long-standing protection of that sector in the EC has sparked a grain subsidy war between the EC and the United States that threatens Canadian exporters. Perhaps of greatest additional concern is the spread of managed trade into other important sectors, including

automobiles, steel, and, potentially, softwood lumber. In 1985, these five sectors together accounted for $90 billion, or 40 percent, of Canada's total trade.[6]

The trend toward managed trade has received little attention in Canada, where trade policy debate has focused on the opportunities and risks associated with negotiating a free trade area (FTA) agreement with the United States. To some international observers, the recent interest in a Canadian-U.S. FTA is further evidence of the tendency to turn away from the multilateral GATT framework for trade liberalization in favor of bilateral deals, which, by their very nature, discriminate against third countries. To others, bilateral agreements offer the opportunity for like-minded countries to reduce trade barriers and increase interest in revitalizing the multilateral trading system. Even if an FTA agreement is reached, however, the global trend toward managed trade will have serious implications for Canada. This is because trade in key sectors will continue to be managed internationally, regardless of whether Canada and the United States reach a bilateral agreement.

Sectoral Developments in 1986

The implications for Canada of managed trade can best be illustrated by some examples of a disturbingly increasing number of specific sectoral cases.

Textiles and Clothing

Trade in textiles and clothing is governed not by GATT rules but by the Multifiber Arrangement (MFA). The MFA, originally negotiated at the end of 1973, was intended to foster an orderly restructuring of uncompetitive textile industries in the industrial countries (including Canada) and gradually to increase access of competitive textile producers in the developing countries to the markets of the industrial countries. The original agreement (MFA 1) was intended to last for four years.

On August 1, 1986, representatives of the EC and 42 individual member countries agreed to a third extension of the MFA. Under this agreement, known as MFA 4, trade in textiles and clothing will remain outside the GATT and will be subject to individually negotiated agreements between producing and consuming nations. MFA 4 is even more restrictive than its predecessors and remains in effect through 1991, demonstrating the tendency for temporary managed trade agreements to become permanent.

Canada, along with the United States and the EC, supported tightening quotas on imports from the developing countries. The developing coun-

[6]Statistics Canada, *Summary of External Trade*, Cat. no. 65-001, December 1985.

tries' governments originally demanded that the MFA be ended altogether but eventually gave up under pressure from their own producing industries, which prefer the higher prices supported by managed trade to the uncertain outcome of a more competitive environment. Not only did the producing countries agree to an extension, they were forced to broaden the restraints to include silk, ramie, sisal, and jute, which were not previously covered by quotas.

At the time the MFA was extended, Canada introduced a new Textile and Clothing Import Policy, which reaffirmed the federal government's intention to negotiate and extend bilateral restraint agreements with 25 low-cost, producing countries. The new policy is intended to prevent disruptions caused by import surges, to moderate the longer-term growth of imports, and to maintain "a viable level of textile and clothing production in Canada."[7] In pursuit of the latter objective, the new policy introduced a duty remission program for imported shirts. Under the program, Canadian producers will be entitled to import one shirt duty free for each shirt made in Canada with domestic fabrics, thereby conferring a subsidy on Canadian-produced fabric and shirts.

The federal government views its policy of managing textile and clothing imports as an attempt to balance the interests of Canadian producers and consumers. In fact, however, the cost to consumers of import quotas alone is between $300 and $350 million per year. Added to this is the cost of tariffs, which average over 20 percent. In a thorough study of textile and clothing protection, Glenn Jenkins of Harvard University estimated that in 1979, the cost to consumers of tariffs and quotas was $780 million.[8] The costs would be substantially higher today. Jenkins also estimated that quotas were responsible for maintaining 6,000 jobs in the textile and clothing industry. The cost of sustaining employment thus amounted to $54,400 per job per year.

Agriculture

Trade in agricultural products is not regulated by GATT rules. In a detailed examination of agricultural trade and pricing policies published in mid-1986, the World Bank demonstrates that agricultural trade restrictions have increased greatly since the 1950s, especially in the industrial countries.[9] Interventions are almost universal and most trade is

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[7]Government of Canada, "New Textile and Clothing Import Policy," *News Release* no. 137, Ottawa, July 30, 1986.

[8]This estimate is reported in Martin Wolf et al., *Costs of Protecting Jobs in Textiles and Clothing*, Thames Essay no. 37 (London: Trade Policy Research Centre, 1984), p. 110. The Wolf et al. study revises estimates contained in Glenn P. Jenkins, *Costs and Consequences of the New Protectionism: The Case of Canada's Clothing Sector* (Ottawa: North-South Institute, July 1980).

[9]World Bank, "Trade and Pricing Policies in World Agriculture," in *World Development Report 1986* (New York: Oxford University Press, 1986).

managed by public-sector agencies and marketing boards. Bilateral trade deals and special preferences have further distorted trade flows in agriculture.

The outcome is a testimony to the gross inefficiency that managed trade can generate. The World Bank puts it bluntly:

> Trade barriers in industrial countries have become more restrictive and most developing countries pursue policies that inhibit the growth of agricultural output and rural incomes. As a result, most of the world's food exports are grown in the industrial countries, where the costs of food production are high, and consumed in developing ones, where the costs are lower.[10]

This situation was greatly exacerbated in 1986 when the United States, frustrated by years of the EC's dumping of agricultural products on world markets at subsidized prices, retaliated with large increases in its own agricultural subsidies. The trade war escalated when the United States offered to sell 4 million tons of wheat to the Soviet Union at subsidized prices. These export subsidies, along with reductions in U.S. domestic price supports, have lowered the world price for wheat by over 25 percent. The Canadian Wheat Board estimates that lower prices and reduced market share resulting from the subsidy war will cost Canadian grain farmers $1 billion in lost income in 1986. During the past three years, Canadian grain sales have declined by 40 percent, to about $3 billion from $5 billion per year.

The damage this subsidy war has caused to other grain-exporting countries led in July 1986 to the formation of a group of 13 countries, including Canada, called the "Fair Traders in Agriculture", which pledged to exert effective political pressure to end unfair subsidies. The group also demanded that agricultural trade be brought under GATT rules. The formation of the group and its failure to obtain a commitment to an early end for export subsidies at the GATT meeting in Uruguay in September 1986 means that grain trade will continue to be determined more by political pressures and subsidies than by comparative advantage.

Automobiles

Trade in automobiles increasingly is conducted outside GATT rules. The increased quality and competitive pricing of Japanese automobiles led to rapid increases in Japanese import penetration of North American and European markets in the 1970s. In response to considerable job losses in their auto sectors and growing political pressures, the United States, the

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[10]Ibid., pp. 8–9.

EC, and Canada each negotiated VER agreements with Japan in the early 1980s. These bilateral agreements limit Japanese auto producers to sales of a specified number of units or to a specified market share in each of the importing countries.

The U.S.-Japanese VER arrangement essentially enjoined Japanese producers to reduce their unit sales and increase their prices in the U.S. market. One study of this arrangement estimates that it increased the price of Japanese cars sold in the United States by U.S.$1,000 per car and the price of North American cars by U.S.$400–800 per car.[11] The study further estimates that the VER saved 26,000 U.S. auto industry jobs at a cost of U.S.$160,000 per job. President Reagan lifted the VER in the spring of 1985 but Japan, fearing worse forms of protection if Japanese car sales surged, initially decided to continue to restrain exports to the United States. In mid-1986, formal restraints were ended.

Canada followed the U.S. lead in imposing a VER on Japanese autos in 1981. Canada's automobile industry operates within an integrated North American market under the Canadian-U.S. auto pact. For this reason, the industry benefited from both the U.S. and Canadian VER agreements with Japan. During the recovery period of 1983–84, these VERs helped Canadian auto producers to increase their output by 50 percent; industry sales, profits and investment increased sharply. The VERs, however, have been a mixed blessing for Canada. Unlike the United States, Canada has not ended its VER but, instead, has renegotiated the agreement several times, most recently in August 1986. The Canadian Association of Japanese Automobile Dealers estimates that in 1985, the VER raised the average price of Japanese cars sold in Canada by $1,250.[12] In negotiating new limits in 1986, the Japanese argued that low-priced imported cars from South Korea be subject to similar restraints. A compromise was reached that increased the allowable market share for Japanese cars to 21 percent from 18 percent and that initiated an "orderly marketing" agreement with South Korea to prevent surges of imports of its low-priced cars.

In conjunction with industrial subsidies and a duty remission program, Canada used its pressure on Japan and South Korea to limit exports as a lever for encouraging increased automotive investment from these countries. Major new investment projects by Honda, Toyota, Suzuki (in a joint venture with General Motors), and Hyundai reflect the potential for combining industrial policies and managed trade to influence the location of investment. Canada's success in attracting such investment has created its own problems, however, by drawing the attention of U.S. congressional

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[11]Robert W. Crandall, "Import Quotas and the Automobile Industry: The Costs of Protectionism," *The Brookings Review* (Summer 1984): 8–16.

[12]Susumu Yanagisawa, "Restraints pushing up price of cars," *Financial Post*, September 6, 1985, p. 8.

members from auto-producing states concerned about overbuilding of automobile capacity in North America. The result has been new pressures from the United States regarding long-standing provisions of the auto pact. In particular, U.S. Trade Representative Clayton Yeutter has indicated that Canada's duty remission program appears to constitute an export subsidy and thus violates the spirit of the auto pact. While the value of duty remission is small, the United States has raised the issue in bilateral trade negotiations with Canada.[13]

Although Canada has resisted the idea of including the auto pact in the bilateral negotiations, a study by University of Toronto economists Melvyn Fuss and Leonard Waverman concludes that the present agreement has not been effective in making Canadian auto production more efficient.[14] They estimate that during the 1962–64 period, Canada's auto industry was 27 percent less efficient than that in the United States. By the early 1970s, this deficiency had been reduced to 19 percent, but was not further reduced by the end of the 1970s. Fuss and Waverman find that only 3 percentage points of the reduction was attributable to rationalization induced by the auto pact.

The explanation of the limited improvement in productivity is two-fold, according to the authors. First, the North American industry remained protected from offshore competition. Second, although the auto pact created an opportunity for rationalization and improved productivity in Canada, the absence of competition-increasing effects in the highly concentrated Canadian industry meant that pressures to cut costs were limited. The Fuss-Waverman analysis and the estimated costs of VERs suggest that managed trade in the automobile sector has been more costly than most Canadians realize.

Steel

The risks to Canada of the drift toward managed trade are further illustrated in the case of carbon steel. World demand for steel has not increased over the past ten years. World steel production capacity now far exceeds demand and this excess is expected to overhang the market for years to come. International trade in steel has become increasingly managed. Each of the major steel consuming areas — the United States, the EC, and Japan — has resorted to export restraint agreements to shield domestic producers. Newly industrializing countries such as Brazil and South Korea increasingly undercut world prices to expand their market shares. In Europe, where VERs remain in force, state subsidies tied to industry restructuring commitments have increased the competitiveness and the exports of European steelmakers.[15]

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[13]"U.S. to oppose duty remission for autos," *Globe and Mail* (Toronto), August 22, 1986, p. B3.

[14]Melvyn Fuss and Leonard Waverman, "The Canada-U.S. Auto Pact of 1965: An Experiment in Selective Trade Liberalization," Policy Study 86-6 (Toronto: University of Toronto, Institute for Policy Analysis, 1986).

[15]Peter D. Sutherland, "A European View of the U.S. Trade Feud," *Wall Street Journal*, April 22, 1986, p. 28.

In this environment, Canada's steel industry is highly vulnerable. With market access closing down and competitive pressure from low-cost imports increasing, Canadian steel producers lobbied the federal government in 1986 to take action on two fronts. First, the industry provided International Trade Minister Pat Carney with information to rebut claims by the U.S. Trade Representative that Canadian companies had broken a commitment to limit Canadian steel exports to 3 percent of U.S. consumption. Canada pointed out that, quite the contrary, it had not undertaken to reduce its share of the U.S. market nor had the United States requested it to.[16] As we noted in *Policy Review and Outlook, 1986*, however, Canada's steel exports to the United States clearly have been under informal restraint and monitoring ever since 1984, when the United States negotiated VERs with Japan and 13 developing countries and simultaneously indicated that it intended to limit overall imports to 18–20 percent of the U.S. market. Following a sharp increase in steel exports to the United States from Canada, Sweden, and Taiwan in the summer of 1986, the United States requested immediate talks with each of these countries to impress on them the need to limit their exports and maintain their traditional market shares.[17]

On a second front, International Trade Minister Carney announced that on the basis of a study of the Canadian steel market conducted by the Canadian Import Tribunal, carbon steel would be placed on the Import Control List in order to facilitate collection of information and to protect against unfair or disruptive steel imports into Canada.[18] While the minister pointed out that Canada was not establishing formal quantitative controls on steel imports, the increased monitoring provides the machinery for such controls should they be deemed necessary.

Current trends point clearly to an unsatisfactory outcome in which competitive Canadian firms find their access to export markets blocked and, at the same time, Canadian steel users are constrained in their ability to purchase low-cost imported steel.

Softwood Lumber

Trade in lumber has long been relatively free of duties or other restraints. This situation is now changing under the pressures for adjustment created by excess capacity in the U.S. lumber industry.[19] U.S. softwood

[16]Government of Canada, "Letter to Ambassador Clayton Yeutter," *News Release* no. 143, Ottawa, August 20, 1986.

[17]"Yeutter is seeking talks on steel exports to U.S.," *Globe and Mail* (Toronto), September 5, 1986, p. B3.

[18]Government of Canada, "Minister for International Trade Releases Canadian Import Tribunal Report on the Carbon Steel Industry," *News Release* no. 135, Ottawa, July 24, 1986.

[19]Two recent analyses of the Canadian-U.S. lumber dispute are Informetrica Limited, "Softwood Lumber and the Canadian Economy," *Monthly Economic Review*, July 1986; and National Bank of Canada, "U.S. Protectionism: The Lumber Issue," *Economic Review*, 2nd Quarter 1986.

lumber production dropped by over 20 percent between 1977 and the recession year 1982. Since 1982, production has recovered but prices and profits remain depressed relative to the late 1970s. U.S. softwood lumber consumption increased rapidly following the 1981–82 recession, but much of the increased demand was met through increased softwood lumber imports from Canadian lumber producers, whose share of the U.S. market increased to 33 percent in 1985 from 19 percent a decade earlier.

A segment of the U.S. lumber industry, represented by the 650-member Coalition for Fair Lumber Imports, has applied pressure to restrict imports of Canadian lumber since the early 1980s. In 1982, the coalition filed a petition for countervailing duties against Canadian imports on the grounds that Canadian lumber received an unfair government subsidy in the form of artificially low stumpage fees — taxes levied by provincial governments for the right to cut trees. In 1983, the U.S. Commerce Department ruled that the stumpage fees did not constitute a subsidy and refused the request for countervailing duties.

The U.S. lumber coalition, however, did not give up its fight. In 1985, it lobbied congressmen in lumber-producing states to propose new legislation to limit Canada's share of the U.S. market. The bill, which contravened GATT rules, did not receive widespread support. As an alternative, the coalition again filed for countervailing duties in May 1986, arguing that legal precedents since 1983 had broadened the definition of subsidies sufficiently to include differences in stumpage fees. It recommended a countervailing duty of up to 36 percent on Canadian lumber.

Canada's initial position was that there had been no material changes in Canadian practices since 1983 and, therefore, there were no grounds for a new investigation.[20] When the U.S. Commerce Department accepted the coalition's petition, Canada complained that the U.S. action constituted "unjustified trade harassment" and requested a special meeting of the GATT Subsidies and Countervailing Duties Committee to review the facts of the case.[21]

After the U.S. International Trade Commission made a preliminary ruling that Canadian imports were injuring the U.S. industry, Canada's resolve to fight the countervail action seemed to erode. There was a growing sense that the U.S. Commerce Department would declare Canada's stumpage fees to be a countervailable subsidy, and estimates indicated that a countervailing duty would reduce Canadian exports by $1.3 to $1.4 billion and employment by 20,000 jobs.[22]

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[20]Department of External Affairs, "Text of Canadian Government Aide-Mémoire on Softwood Lumber delivered by Ambassador Gotlieb to U.S. Secretary of Commerce Boldridge in Washington, D.C., Wednesday, June 4, 1986," *Communiqué* no. 111, Ottawa, June 5, 1986.

[21]Minister for International Trade, "Canadian Statement to GATT Council Concerning U.S. Countervailing Duty Petition Against Canadian Softwood Lumber," *Communiqué* no. 117, Ottawa, June 17, 1986.

[22]Informetrica Limited, "Softwood Lumber and the Canadian Economy."

In a move that presages the emergence of managed bilateral trade in lumber, Canada asked the U.S. Commerce Department to delay its ruling on whether Canadian lumber exports are subsidized to give the federal and B.C. governments time to reconsider the stumpage system and lumber taxation more generally. British Columbia announced plans to review forest management practices, which could lead to higher stumpage fees. The federal government and the producing provinces met in late September 1986 to put together a proposed package of changes to stumpage fees that would raise export prices of Canadian lumber and, it was hoped, appease the U.S. lumber coalition. The coalition, however, rejected the Canadian proposal. The U.S. Commerce Department ruled in October that it considered Canada's stumpage practices to be countervailable subsidies and it imposed a 15 percent duty.

This case graphically illustrates how U.S. trade laws can impose pressures on Canada's domestic economic policies. To avoid paying the countervailing duty, the producing provinces can seek a "suspension agreement" if they are prepared to change their stumpage practices. This approach is preferable to paying a 15 percent duty to the U.S. Treasury because the proceeds of higher lumber prices would be kept in the producing provinces. Canada does have avenues, however, to challenge the U.S. ruling, including appeals both to the U.S. courts and to the GATT.

Failure to overturn the lumber ruling would set an important precedent. Other U.S. industries could follow the lead of the lumber coalition and use U.S. countervailing duty laws to attempt to dictate terms of access for imports into the U.S. market. The result could be a new, more confrontational era of Canadian-U.S. relations.

Free or Managed Trade: Canada's Options

Several general observations can be drawn from these sectoral developments:

- Managed trade, which ignores GATT principles, is firmly entrenched in agriculture, textiles, and clothing. Developments in 1986 suggest that the distortion of trade and investment in these sectors is growing, not diminishing.
- The failure of managed trade policies to manage the reduction of excess capacity in an efficient way is evident from the experience of agriculture and textiles. Yet, the practice is spreading to other important sectors.
- In each of the sectors, trade flows increasingly are determined by governments responding to political pressures from domestic producers who resist the need to adjust to shifting global comparative advantage.

- While managed trade agreements sometimes temporarily resolve trade frictions between countries, they do so at a high cost that is ultimately borne by consumers. They save jobs in the protected sector, but the cost of preserving each job far exceeds the benefits.
- Countries such as Canada, with small domestic markets, are most vulnerable to managed trade arrangements. Their access to large export markets is constrained; at the same time, they face domestic pressures to keep out low-priced imports. The result is reduced productivity in export industries forced to operate well below capacity and higher costs for imports. The cumulative effect of managed trade as it spreads over time and across industries is to reduce living standards, to create vested interests in protection, and to increase the ultimate costs of adjusting to meet international competition.

As the GATT Secretariat points out in its latest annual report, the worldwide spread of managed trade, marked by increased protection and retaliation, risks producing a stagnation — or decline — in world trade sufficient to bring about a premature end to economic expansion.[23] There is little Canada could do to avert this outcome.

Canada does, however, have options that might at least reduce the threat managed trade poses to export market access and domestic productivity. One is to negotiate a broad trade agreement with the United States, Canada's largest trade partner and a source of much of the managed trade pressure Canada faces. Another option is to pursue a return to GATT disciplines and the extension of GATT rules to agriculture, textiles, and new areas such as trade in services through the Uruguay Round of multilateral trade negotiations. Other approaches include the unilateral option of resisting domestic pressures for protection, and the plurilateral option of seeking to negotiate improved market access with trading partners other than the United States. Clinging to an eroding status quo is not a viable option. Without a broad trade agreement that provides more secure access to principle export markets and that forces Canadian firms to adjust to international competitive pressures, the boost to Canadian living standards that international trade traditionally has provided will diminish.

Bilateral Negotiations

Bilateral negotiations have been the almost exclusive focus of Canadian trade policy debate in 1986. There is an appealing logic to the notion that, since 80 percent of Canada's trade is with the United States and since the U.S. market of 240 million people would permit Canadian firms to achieve economies of world-scale production, Canada can meet most of its trade objectives through bilateral negotiations.

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[23] *GATT Focus*, no. 40, July–August–September, 1986, p. 5.

Much of the support for the federal government's bilateral trade initiative stem from concern about the rising tide of U.S. protectionism. In the minds of many, the benefits of rationalization of Canadian industry within the larger North American market are a secondary consideration. Others, such as C.D. Howe Institute economists Richard Lipsey and Murray Smith, argue that only a broad FTA agreement has a chance of achieving the benefits of rationalization as well as limiting protectionist abuses of countervail and other U.S. trade laws.[24]

It will be difficult, however, to conclude a broad agreement in 1987. The Reagan administration's negotiating authority expires on January 3, 1988. Although the administration will seek an extension of this authority for both bilateral and multilateral trade talks, recent experience suggests that the price of an extension is likely to be new protectionist amendments to U.S. trade laws.

Multilateral Negotiations

Even if a bilateral agreement can be reached, it will not fully resolve Canada's problems in managed trade sectors, simply because many of the problems are global rather than North American in nature. World trade in grain, textiles, clothing, steel, automobiles, semiconductors, and a growing list of other products of importance to Canada will continue to be managed by governments.

The Uruguay Round, therefore, is a second important way to address protectionism and the spread of managed trade. Canada has been a strong supporter of the new round and has indicated that its objectives include a freeze and rollback of protectionist measures that do not conform to GATT rules, an urgent reform of the rules for agricultural trade, and tighter disciplines on the use of contingent-protection measures, including countervailing duties. Because success in these areas would meet Canadian objectives that may not be achieved in bilateral talks, Canada has no alternative but to give high priority to the multilateral approach. Nevertheless, it is difficult to be optimistic about the chances for an early reversal of protectionism in the Uruguay Round. In order to obtain agreement on the agenda for the negotiations, the officially declared objectives were made vaguer, especially in the areas of agriculture and services. The negotiations will run for four years. When they are concluded, another ministerial meeting will be scheduled for 1990 or 1991 to determine whether the results should be incorporated into the GATT framework.

An important test of the credibility of the Uruguay Round will be the so-called standstill and rollback commitments, which pledged GATT mem-

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[24]Richard G. Lipsey and Murray G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27 (Toronto: C.D. Howe Institute, 1985).

bers to take no new trade restricting or distorting measures inconsistent with GATT rules and to phase out or bring into conformity with GATT rules all existing measures that restrict or distort trade. Will GATT members refrain from requesting new VERs and convert existing VERs into measures consistent with the GATT? If they do, the erosion of GATT rules could come to an end. If they do not, the standstill and rollback commitments will not prevent the further spread of managed trade nor the further erosion of GATT rules.

Canadian-U.S. bilateral negotiations, if successful, could provide a valuable model for multilateral negotiations. A broad bilateral agreement that involves stricter rules governing application of trade laws, and new rules for trade in services, intellectual property, and foreign investment could act as an important catalyst in the Uruguay Round. But Canada's initiative is a two-edged sword, in this respect: failure to reach agreement could make multilateral progress on these matters even more difficult. Failure by the United States to reach an agreement with its largest trading partner and closest neighbor could lead to a further lapse toward inward-looking protectionist policies.

Other Options

While both bilateral and multilateral trade negotiations are essential avenues for promoting Canada's trade objectives, neither is a panacea. Other avenues need to be considered. One is a unilateral decision by the federal government to resist domestic pressures for policies that restrict and distort trade; in particular, it should not respond to foreign protectionist measures by restricting access to the Canadian market.

Another avenue is a plurilateral approach — that is, agreements between groups of countries to reduce barriers to trade within the group — that seeks to build on the trade liberalization that may be achieved in Canadian-U.S. bilateral negotiations. Canada's best hope of expanding its exports may come from offering to its other major trading partners similar access to that offered the United States, in return for improved access to their markets.

Conclusion

Canada participates in a highly interdependent world economy. This interdependence provides Canadians with opportunities to participate in world markets for ideas, labor, capital, goods, and services. Yet interdependence also means that none of the industrial countries can pursue macroeconomic and trade policies without first considering the policies adopted by other countries. For a small country such as Canada, charting a viable policy course in an interdependent world requires both a

realistic assessment of the international constraints and the will to use the options available to improve the prospects for sustained growth.

Until recently, Canada has been content with a passive role in international debates about appropriate macroeconomic and trade policies. But it can no longer afford to stand on the sidelines. Canada's entry into the G-7 discussions of international macroeconomic and exchange-rate policy is an opportunity to influence the policies of its major economic partners. And with the initiation of bilateral trade negotiations with the United States and involvement in the Uruguay Round of multilateral trade negotiations, Canadians are beginning to look outward. To be influential, Canada will have to propose thoughtful solutions and back them up with constructive domestic policies. Even if cooperative solutions cannot be found, domestic policies that focus on increasing flexibility and reducing vulnerability to external pressures can improve Canada's chances for success in a changing world.

4

Succeeding in a Changing World

The world economy is experiencing turbulent times that will continue in 1987. Almost daily, Canadians are reminded that international market forces have a dominant influence on the pace of Canadian economic activity and on its distribution across the country. Canadian policymakers continually are confronted with the hard lesson expressed in a recent Trilateral Commission report:

> [I]n today's interdependent world, any national policy which long remains incompatible with those of other major countries will inevitably become unsustainable, and thus levy severe costs on the country initiating such a policy.[1]

More positively, the lesson is that economic policies are most likely to succeed in improving domestic performance if they focus on increasing the adaptability and international competitiveness of the economy. When sailing in rough and unpredictable seas, there is no better security than a seaworthy vessel, an able crew, and a determined captain ready to respond quickly to changing conditions. If any of these ingredients is missing, the only choice is to run helplessly before the wind.

In this chapter, we outline a strategy that focuses on maximizing Canada's chances of economic success in a changing world. The chapter begins with the Institute's view of the international context in 1987. It then identifies six key policy areas where progress in 1987 can contribute to Canada's ability to adapt successfully to external pressures and makes appropriate recommendations.

The International Context

In Chapter 3, we discussed two scenarios for the near-term prospects for the world economy. In one view, changes already under way are working through the world economic system and will generate a pickup of noninflationary growth in the industrial countries in the second half of 1986 that will continue in 1987. A second view anticipates that the

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[1]C. Fred Bergsten, Etienne Davignon, and Miyazaki, *Conditions for Partnership in International Economic Management*, The Triangle Papers no. 32 (New York: Trilateral Commission, 1986), p. 38.

failure of the United States, Japan, and Europe to coordinate their macroeconomic policies will bring about recession and further heighten protectionism. These widely different views of the future course of the world economy highlight the uncertainty policymakers face in 1987.

The Institute's view is that the outlook is favorable but risks from U.S. policy are considerable. By late 1986, there were some signs of improvement in key indicators. The U.S. trade deficit showed signs of a possible turnaround in the third quarter of 1986 — a turnaround that could help contain U.S. protectionism. Although indications are that oil prices will fluctuate within a range of U.S.$12–18 per barrel for the foreseeable future, there were signs that nonenergy resource prices had stabilized, with the possibility of a modest turnaround in 1987. In North America, the household sector continued to support economic expansion and confidence about the future was reasonably sound.

It was also evident by late 1986 that changes in national policies were under way that could lead, slowly, to policies that are better coordinated. West German Finance Minister Stoltenberg announced intentions to move tax cuts forward into 1987 to strengthen his country's domestic spending and competitiveness. Japanese Prime Minister Nakasone committed to restructure the Japanese economy to rely more on domestic demand in ways recommended in the far-reaching Mayekawa Report.[2] These decisions are clearly in the right direction, although it is unrealistic to expect changes to occur overnight.

The key factor contributing to uncertainty in 1987 is the absence of credible progress by the United States in reducing its budget deficit. The U.S. deficit for the fiscal year that ended September 30, 1986, was U.S.$220 billion — U.S.$40 billion higher than projected, in spite of Gramm-Rudman-mandated cuts of U.S.$12 billion. Skepticism that accompanied the October 1986 budget bill to meet the Gramm-Rudman deficit target of U.S.$144 billion in fiscal year 1986–87 appears to be warranted. In 1987, a deficit in the range of U.S.$180–190 billion is widely expected; slower growth could keep the deficit above U.S.$200 billion. Without an effective deficit reduction plan in place, U.S. borrowing will keep global imbalances in financial and trade flows large.

Despite this muddling-through policy environment, we expect the industrial economies to continue to grow in 1987. The bottlenecks and inflationary overheating that normally precede a recession are nowhere in sight. The risk exists — and it is not to be discounted — that frustration and impatience with the slow turnaround of the U.S. budget deficit and current account deficit will breed protectionism and precipitate costly policy mistakes. A loss of confidence in the ability of the United States to cope with its problems could produce a major disruption in the world economy.

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[2]Japan, Advisory Group on Economic Structural Adjustment for International Harmony, "Report," submitted to the Prime Minister, Mr. Yasuhiro Nakasone, Tokyo, April 7, 1986.

Canada obviously has much at stake in the way world economic developments unfold in 1987. In the present environment, domestic growth will continue, but not fast enough to lower unemployment significantly. Inflation, already the highest among the seven major industrial countries, shows little sign of moving down. Now is clearly not the time for Canadians to congratulate themselves. Much remains to be done to transform the Canadian economy in ways that improve international competitiveness and increase flexibility.

Canada's Economic Policy Strategy

In key policy areas, Canada can improve its chances of economic success in 1987 and beyond if it presses ahead to promote adaptability within the economy. The constraints on bringing about these policy changes are made-in-Canada constraints — namely, pressures to maintain the status quo from interest groups within Canada. Yet, as we pointed out in *Policy Review and Outlook, 1986*, attempts to delay change and preserve the status quo only increase the size and the cost of inevitable adjustments.

Six issues are likely to dominate the 1987 policy agenda:

- sustaining and broadening Canada's economic expansion;
- reducing budget deficits;
- reforming the tax and transfer system;
- reforming labor market policy;
- adopting industrial policies that are more consistent with trade policy objectives; and,
- improving Canada's access to world markets in the face of the spread of managed trade.

Moves already have been made in all of these areas. The challenge in 1987 is to sustain the general direction, where it is consistent with Canada's long-term objectives, in spite of unexpected pressures that might blow policy off course.

Macroeconomic Policies for Sustained Expansion

In Washington in September 1986, finance ministers and central bankers of the Group-of-Seven (G-7) industrial summit countries, including Canada, met for the first time to discuss ways of achieving better coordination of macroeconomic policies. The meeting was set against a backdrop of disagreements among the United States, West Germany, and Japan about the appropriate conduct of macroeconomic policy in each country.

Canada attempted to play a mediating role at the G-7 meeting and at the subsequent meeting of the International Monetary Fund. The significance for Canada of the G-7 meeting, however, was that it increased Canada's commitment to and responsibility for coordinating its macroeconomic policies with those of other member countries. In 1987, the most constructive contribution Canada could make to improved coordination would be to reduce its large government budget deficits, which have persisted since the 1981–82 recession and which have contributed to international imbalances.

In fact, the scope for fiscal stabilization policy in Canada is virtually nonexistent because of the rapid accumulation of debt that has occurred since 1982. Any attempts to offset weakness in economic activity with expansionary fiscal policy would risk explosive growth in both debt and interest payments. The ensuing loss of confidence inevitably would lead to speculation against the Canadian dollar, which, in turn, would force a reversal of fiscal policy and a temporary increase in Canadian interest rates to end that speculation.

With independent fiscal policy out of the question, Canada's monetary policy has assumed most of the burden of sustaining economic expansion. Yet Canada's scope for independent monetary policy also is limited.

Now that Canada is a member of the G-7, an important question that arises is whether pressures will be created that will affect Canada's monetary policy flexibility. Canada's commitment to more active involvement in international policy coordination runs counter to a view recently expressed by William Lawson, former Senior Deputy Governor of the Bank of Canada:

> I would not expect to see much enthusiasm in Canada for any international initiative that looked towards commitments in the exchange-rate or balance of payments fields. The belief in Canada that freedom from such commitments gives valuable freedom of maneuver to domestic economic policy is too strong for that. It may be that this belief will be reconsidered, and I hope that it will because I think that the case for it is much more doubtful than is commonly supposed. . . Much of the exchange-rate depreciation that Canada has experienced over the last decade seems in retrospect to have been used to avoid dealing with a considerable range of domestic policies and practices that need adjustment.[3]

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[3]R. William Lawson, "A Canadian Perspective," in Bergsten, Davignon, and Miyazaki, *Conditions for Partnership in International Economic Management*, p. 55.

Lawson's comment underlines the idea that exchange-rate depreciation is no shortcut to improved international competitiveness if government policies and private-sector practices are not adjusted to changing world conditions. Without such adjustment, the Bank of Canada's ability to resist depreciation over the longer term is reduced.

In a recent study of Canadian monetary policy during the 1982–85 period, Peter Howitt of the University of Western Ontario argues that the Bank of Canada has tended to overemphasize the importance of the Canadian-U.S. dollar exchange rate in setting monetary policy.[4] Howitt contends that the Bank should have focused on an appropriate weighted-average exchange rate that takes account of the exchange rates of all of Canada's major competitors in world trade.[5] During the 1981–84 period, for example, while the Canadian dollar was depreciating from U.S.$0.84 to U.S.$0.73, Canada's exchange rate relative to all its major competitors actually appreciated by about 5 percent. In Howitt's view, stabilizing the effective exchange rate would have permitted a lower Canadian-U.S. exchange rate, and a more rapid return of Canada's broadly defined money supply to a level consistent with high employment. Howitt also argues that monetary policy should focus less on stabilizing exchange rates and more on ensuring that growth of the broadly defined money supply does not deviate for long from a rate consistent with continued economic growth and price stability. With this approach — which Howitt calls Adaptive Monetary Control — in the event of a downturn in the world economy, the Bank would focus more on maintaining stable monetary growth than on any particular exchange rate.

In our view, the Bank's ability to conduct policy as Howitt suggests depends on the progress made in other policy areas — including deficit reduction, tax reform, labor market policy, and trade and industrial policies. Until such progress is evident, the Bank will have to continue to balance movements in both the broad monetary aggregates and the effective exchange rate to help sustain noninflationary growth.

Recommendation 1: Canada should contribute to international macroeconomic policy coordination, both as a catalyst and as a model for other large industrial countries. Because its large

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[4]Peter Howitt, *Monetary Policy in Transition: A Study of Bank of Canada Policy, 1982–85*, Policy Study no. 1 (Toronto: C.D. Howe Institute, 1986).

[5]A superior estimate of the weighted-average exchange rate is the so-called effective exchange rate index published by the International Monetary Fund. The advantage of the IMF effective rate is that it accords weights in the exchange-rate index not only to countries with which Canada has a large bilateral trade relationship but also to competitors with which Canada does relatively little trade. The IMF rate is calculated using the Multilateral Exchange Rate Model described in Jacques R. Artus and Anne Kenny McGuirk, "A Revised Version of the Multilateral Exchange Rate Model," *IMF Staff Papers* 28 (June 1981): 275–309.

government budget deficit contributes to global macroeconomic imbalances and reduces confidence in its economic prospects, Canada's priority in international coordination should be deficit reduction. The Bank of Canada should focus on providing a rate of monetary expansion and an effective exchange rate that promote sustained, noninflationary expansion.

Reducing Budget Deficits

A major source of Canadian vulnerability in the current international environment is the continuing accumulation of public debt created by large and persistent budget deficits. The February 1986 federal budget presented a medium-term fiscal plan designed to restore fiscal stability by reducing the growth of the debt so that, by the end of the decade, it no longer exceeds the growth of the economy.

As discussed in Chapter 1, developments in 1986 demonstrate the vulnerability of the fiscal plan. Slower-than-anticipated growth and actions taken to offset the impact of lower oil and grain prices led to a revenue shortfall and a revised federal deficit projection for fiscal year 1986–87 of $32 billion. The shortfall clearly indicates the sensitivity of the medium-term deficit projections to changes in the international economic environment. As the Department of Finance pointed out in a background paper to the February 1986 budget, in an unfavorable international environment characterized by below-trend growth and little reduction in real interest rates, the budgetary deficit would remain around $35 billion and the debt-to-GNP ratio would rise continously.

> In a situation where real interest rates continuously exceed real economic growth the fiscal situation is potentially explosive. In such circumstances debt and interest payments as proportions of GNP rise without limit. . .To prevent the debt and interest payments from rising explosively, the *primary* budget balance, that is to say the budgetary deficit less net interest payments, has to be in surplus. Achieving this surplus is then essential prerequisite for first stabilizing and then reversing the trend in the debt-to-GNP ratio.[6]

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[6]Department of Finance, *The Fiscal Plan* (Ottawa, February 1986), p. 68. The basic dynamic equation of deficit and debt is:

$$\dot{d} = x + (r-g)d$$

where d is the ratio of debt to GNP and $\dot{d}$ is its change over time, x is the primary deficit, which excludes interest payments on the debt, r is the interest rate, and g is the growth rate of GNP. If both x and d are positive, and r exceeds g, $\dot{d}$ must be positive and will remain so as long as these conditions remain true. In Canada, the current situation at the federal level is that d is positive and r exceeds g. Therefore, $\dot{d}$ can only be reduced to zero if x is negative — that is, if the government achieves a primary surplus.

The federal government has made progress in achieving a surplus in the primary budget balance, as shown in Table 7. In the first half of 1986, it collected more in revenue than it spent on programs — for the first time since the early 1970s. The achievement of a primary surplus and the fall in nominal interest rates combined to reduce federal interest payments as a percentage of GNP for the first time in over a decade. These reversals indicate that deficit-reduction measures taken after November 1984 were beginning to show results by early 1986.

The Institute remains highly concerned about budget deficits, for two reasons. First, the revenue shortfall and new spending pressures could blow the fiscal plan off course, renewing the growth of debt and interest payments. Some of the factors that produced the shortfall in corporate tax revenues are unlikely to be reversed quickly. New promises — such as $1 billion for Canadian farmers and more money for economic development programs for Atlantic Canada — have not been accompanied by indications of where the money will come from. Second, progress made in improving the federal fiscal position in the first half of 1986 was offset by a deterioration in the fiscal position of the provinces, as shown in Table 7. The restraint that is apparent in federal spending is absent in the provincial government sector. The balanced overall provincial budget of 1980 has turned into a large and growing deficit. As provincial debt has risen, it has pushed up provincial interest payments as a proportion of GDP.

Provincial government finances have deteriorated because budget deficits are rising in the resource-producing provinces, where economic performance is weak, and are not falling fast enough in provinces, such as Manitoba, Ontario, and Quebec, where economic performance is stronger. If Canada's overall public debt problem is to be controlled, not only will the federal government's commitment to medium-term deficit reduction need to be re-established in the next budget, but the faster-growing provinces will have to accelerate actions to reduce their provincial budget deficits.

New deficit-reduction measures should focus on the expenditure side of government budgets. Taxes have been increased both federally and provincially in recent years. With the United States moving to lower tax rates in 1987, further raising Canadian tax rates would be counterproductive. At the federal level, avenues for expenditure control identified by the Neilsen Task Force on Program Review in 1985 should be pursued in 1987 in order to keep deficit reduction on target, to free up resources to deal with new priorities, and to improve the effectiveness of government operations. At the provincial level, the key is a renewed commitment to expenditure restraint. In Quebec, the report of a provincial task force on expenditure control challenged Quebecers to find ways to stream-

Table 7
Federal and Provincial Fiscal Indicators, 1980, 1985–86

	1980	1985		1986
		1st half	2nd half	1st half
		($ billions)		
Federal government				
Program expenditures	$51 4	$92 7	$88 6	$87 4
Revenue	50 7	83 3	84 1	88 8
Primary surplus or deficit	-0 8	-9 5	-4 5	1 4
Interest payments	9 9	24 9	25 6	25 2
Total surplus or deficit	*-10 7*	*-34 4*	*-30 1*	*-23 9*
Provincial governments				
Program expenditures	55 0	91 2	92 5	96 6
Revenue	59 3	96 7	100 6	100 6
Primary surplus or deficit	4 3	5 4	8 1	4 0
Interest payments	4 8	11 3	12 0	12 6
Total surplus or deficit	*-0 6*	*-5 9*	*-4 0*	*-8 6*
		(percentage of GDP)		
Federal government				
Program expenditures	16 6%	19 8%	18 2%	17 5%
Revenue	16 3	17 8	17 3	17 8
Primary surplus or deficit	-0 2	-2 0	-0 9	0 3
Interest payments	3 2	5 3	5 3	5 1
Total surplus or deficit	*-3 4*	*-7 4*	*-6 2*	*-4 8*
Provincial governments				
Program expenditures	17 7	19 5	19 1	19 4
Revenue	19 1	20 7	20 7	20 2
Primary surplus or deficit	1 4	1 2	1 7	0 8
Interest payments	1 6	2 4	2 5	2 5
Total surplus or deficit	*-0 2*	*-1 3*	*-0 8*	*-1 7*

Source: Statistics Canada, *National Income and Expenditure Accounts*, Cat. no. 13-001, various issues.

line and reduce the cost of providing public services.[7] Ontario, the province with the strongest economy, has a national responsibility to take the lead in stabilizing and reducing overall provincial government deficits. With revenues growing strongly, Ontario can achieve this objective simply by refusing to undertake expensive new programs.

Recommendation 2: The federal and provincial governments should renew efforts to cut budget deficits. Governments in faster-

[7]Québec, Groupe de travail sur la révision des fonctions et des organisations gouvernementales, *Rapports* (Québec, 1986).

growing provinces — Ontario, Manitoba, and Quebec — should move quickly to restrain spending sufficiently to balance their budgets. The federal government should ensure that it stays on course in reducing the growth of the debt so that, by the end of the decade, it no longer exceeds the growth of the economy. Assuming that economic growth continues around 3 percent, to achieve this medium-term objective, the government should take the necessary steps, preferably on the expenditure side of the budget, to lower the deficit to $26 billion in fiscal year 1987–88. By achieving this target — the level projected in the February 1986 budget — the government will avoid a crisis of confidence that can be expected if it allows itself to be blown off course in a relatively favorable economic environment. If growth is less than 3 percent, the government should accept the resulting revenue shortfall, but intensify expenditure restraint to avoid losing sight of the medium-term objective.

Tax Reform

Comprehensive reform of Canada's tax system is potentially one of the most powerful policy instruments for encouraging adjustment and improving Canada's long-term economic performance. By lowering marginal tax rates for individuals and corporations, by shifting the tax base away from income and toward consumption, and by equalizing tax rates across industries and activities, tax reform can encourage work and saving and lead to a more efficient allocation of capital. In the short term, however, radical changes in the tax system can create transitional problems that cause uncertainty and reduce economic activity.

In Chapter 2, we identified four steps to tax reform that would meet both populist and tax policy specialists' concerns about the existing system. The steps are: to introduce a business transfer tax to replace the existing federal sales tax, to broaden the base and reduce marginal tax rates in the personal income tax, to complete base broadening and reduce variability in corporate tax rates, and to improve federal-provincial tax integration. These steps represent the general direction in which the Institute believes Canada's tax system should move.

Recommendation 3: The federal government should "make haste slowly" in introducing comprehensive reform of Canada's tax system. This means providing a blueprint for reform of the entire system in the next budget, a timetable for implementation, complete with transitional arrangements, and an effective process for consultation with provincial governments and the private sector.

Labor Market Policy

The Commission of Inquiry on Unemployment Insurance (the Forget Commission) and the Newfoundland Royal Commission on Employment and Unemployment (the House Commission) have regenerated interest in reforming Canada's labor market policies to increase flexibility and to help bring down unemployment.[8] Much discussion of labor market policy focuses on Canada's unemployment insurance (U.I.) program. Yet, U.I. is only part, albeit an important part, of Canada's overall labor market or human resource policies.

To be effective in the 1980s, a human resource strategy must confront both the global competitive forces and the domestic social and demographic changes that influence employment and participation in the labor force. This means that policy should be directed toward ensuring an educated, skilled, and adaptable work force, toward providing increased flexibility and choice on the part of employers and employees in reaching mutually advantageous working patterns, and toward providing unemployment insurance and income security programs that cushion the impact of change yet encourage the retraining and relocation necessary to match people with job opportunities.

A rebalancing of Canada's efforts in labor market policy is needed. Resources should be reallocated toward programs that increase the skills and flexibility of Canada's work force and away from programs, such as existing publicly financed short-term job-creation programs and regionally extended unemployment insurance benefits, that discourage adjustment and create dependency on government.

Proposals for reform of the U.I. program and other elements of Canada's social safety net cannot avoid being controversial. Cool heads and clear ideas are the prerequisites of progress in social policy reform. That these have been in short supply in Canada in recent years is the primary reason why change has not occurred. It is ironic that those who seek to strengthen the social safety net by reforming it are cast as the system's enemies, while those who contribute to the ineffectiveness of the system by insisting that it be unchanged are cast as its friends.

Recommendation 4: The federal government should accord high priority in 1987 to reform of Canadian labor market policy, including unemployment insurance, as part of an overall strategy

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[8]Canada, Commission of Inquiry on Unemployment Insurance, *Report* (Ottawa, forthcoming); and Newfoundland, Royal Commission on Employment and Unemployment, *Building on Our Strengths* (St. John's, 1986).

for increasing flexibility and eliminating poverty traps. Changes to U.I. should focus on returning the program to insurance principles and removing regional differences in unemployment benefits. Changes in these directions should be made gradually and should be accompanied by improved training, employment, and income security programs that cushion the impact on regions of high unemployment and that facilitate creation of stable employment opportunities.

Climate-Creating Industrial Policies

One of the key assumptions on which economic policy should be based is that because the Canadian economy is so open to international trade and capital flows, it is best served by policies that encourage adjustment to changing international circumstances. In this context, significant steps have been taken in recent years in adopting more market-oriented policies in important sectors of the Canadian economy. Deregulation of the oil and natural gas, transportation, and securities industries will encourage continued growth and competitiveness not only in these sectors but also in others that use energy, transportation, and financial services. These sectoral initiatives are promising. There has been less progress, however, in defining new directions for the broad conduct of industrial policy. The existing policies of the Department of Regional Industrial Expansion and the traditional dispensation of industrial subsidies in general have come under attack. Representatives of large and small business have called for less government intervention, including fewer subsidy programs.

With existing arguments supporting targeted industrial policies coming under attack from theorists and existing methods under attack from policy analysts and from industry itself, many new approaches currently are being debated. New theories of international trade and industrial organization are spawning intriguing new suggestions for fruitful lines of industrial policy.[9]

In the Institute's view, industrial policy should be oriented toward making Canadian industry more competitive, by relying more on policies that create a positive climate for investment, risk-taking, and innovation. Lower marginal tax rates, fewer regulations that stifle competition, and trade policies that secure market access and that encourage industry rationalization and adjustment can do far more to improve Canada's industrial competitiveness than government tinkering with markets. In the years ahead, governments may have to learn to do less and to concentrate on what they do best: providing necessary infrastructure through public investment and encouraging competitive performance through government procurement.

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[9]Richard G. Lipsey and Wendy Dobson, eds., *Shaping Comparative Advantage* (Toronto: C.D. Howe Institute, forthcoming).

Recommendation 5: In the field of industrial policy, federal and provincial governments should focus on providing a coordinated framework of tax, trade, and regulatory policies that encourage industrial competitiveness. Emphasis on industrial subsidies should be reduced. New ideas for coordinating industrial and trade policy objectives are being debated, but implementation of these new ideas under conditions that maximize the chances of success should lie in the future, not in the present.

Trade Policy

The problems Canada's export industries have encountered in maintaining secure access to export markets have become the focal point of Canada's participation in two sets of trade negotiations that will be carried on in 1987. As pointed out in Chapter 3, the spread of protectionism and managed trade from traditional sectors such as textiles and clothing into other sectors of critical importance to Canada — especially grain, steel, and lumber — has raised the stakes in trade talks.

Canada has a clear interest in reducing trade barriers of all types and strengthening the liberal rules of world trade. But the events of 1986 point to two areas of critical importance to Canada: limiting the aggressive application of countervailing duties and other trade remedy laws, and containing the spread of voluntary export restraint (VER) agreements. These practices represent the greatest threat to Canada's security of access to foreign markets and to Canada's economic sovereignty.

Trade disputes involving softwood lumber and steel have provided clear evidence that pressures applied by large trading partners not only result in the loss of export markets but also force Canada to alter domestic policies. Threats of countervailing duties and VERs are presently the greatest source of pressure for harmonizing Canadian economic policies with those of the United States.

As C.D. Howe Institute analyst Murray Smith points out in a recent examination of the issue in the context of bilateral Canada-U.S. negotiations:

> Since the inception of Canada's initiative, Canadian ministers have stressed that greater security of access was an absolutely key Canadian objective in bilateral negotiations. . . Yet, congressional leaders and administration spokesmen have suggested that the United States is very unwilling to alter its existing trade laws and procedures which apply to imports from Canada.
>
> An impasse over the negotiation of the application of trade laws is quite possible and, if it occurred, likely would jeopardize the entire bilateral trade negotiations.[10]

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[10]Murray G. Smith, "Bilateral Negotiation of Trade Laws: Possible Approaches," in Murray G. Smith, C. Michael Aho, and Gary N. Horlick, *Negotiating Trade Laws: Opportunities for Canada and the United States* (Toronto; Washington, D.C.: Canadian-American Committee, forthcoming).

From a Canadian perspective, failure to control application of countervailing duties and pressures for VERs greatly limits the potential gains from bilateral reductions of more visible tariff and nontariff barriers. From a U.S. perspective, aggressive application of trade laws has become the first line of defense against what Americans perceive as unfairly subsidized or dumped imports. Altering the trade laws for Canadian imports, which U.S. protectionists often point to as subsidized, is viewed as damaging both in economic terms and as a legal precedent.

What is insufficiently recognized in the United States is that aggressive application of U.S. trade laws and negotiation of VERs is not in the United States' long-term interest, for two reasons. First, there is ample evidence that both of these forms of protection significantly increase prices for U.S. consumers and slow down adjustment to changing comparative advantage. U.S. consumers of clothing, automobiles, steel, fish, semiconductors, and softwood lumber pay significantly more for these products today than they would without aggressive application of trade laws. Second, present U.S. trade policy makes it easier for other countries to justify circumventing rules established under the General Agreement on Tariffs and Trade (GATT), thereby contributing to the general erosion of the multilateral trading system. The United States has been a major beneficiary of liberal world trade in the postwar era, yet its recent trade policies contribute to eroding the system.

Because of U.S. resistance to negotiating trade laws, Canada must be prepared to show flexibility on issues that U.S. trade negotiators accord high priority. As Smith points out, "While Canada's primary goal in the trade negotiations is to achieve a more open and predictable trade regime, the primary goal for the United States is to secure a more open and predictable environment for investment."[11] If Canada is to gain more secure access to the U.S. market, it will have to work constructively toward new rules dealing with U.S. concerns about Canadian restrictions on trade in services and Canada's tendency to change unilaterally the rules governing foreign investment and the protection of intellectual property. Both countries would benefit from a more predictable bilateral trade and investment climate.

While bilateral negotiations will continue to be the focus of Canadian public attention in 1987, Canadian negotiators also now have the opportunity to use the Uruguay Round of multilateral trade negotiations as a forum to strengthen trade rules and expand access to export markets. Indeed, some issues, including agricultural export subsidies and the global spread of managed trade, can only be dealt with in a multilateral context. Canada's objectives in bilateral and multilateral negotiations are mutu-

[11] Ibid.

ally consistent. But neither the bilateral nor the multilateral negotiations, by themselves, are capable of dealing with the entire range of objectives. In the event that bilateral negotiations over trade laws and investment rules reach an impasse, Canada's best remaining option will be to find allies within the GATT to help it meet its trade objectives.

Protectionism and export subsidies that injure Canadian export industries and weaken the world trading system have yet to elicit a clear and unified response from Canadians. Much of the debate over Canadian-U.S. trade negotiations, useful as it has been in forcing Canadians to look outward, has diverted attention from the ongoing breakdown of liberal rules of international trade.

Debates about the potential impact of a Canadian-U.S. free trade area on jobs, on Canadian cultural industries, and on Canadian sovereignty are important; but there is a risk that this will turn out to have been like debating the deck chair arrangement on the *Titanic* as it approached the fateful iceberg.

Canada's negotiating position in bilateral and multilateral trade talks, both of which are critical to Canadian objectives, would be strengthened by a shared recognition that if current trends persist, all Canadians will suffer. The position some take that the two sets of negotiations are inconsistent is a damaging shibboleth. The reality is that bilateral and multilateral approaches are two indispensable avenues for advancing Canada's interests in the world economy. Without a common perception of the external threat, Canadians risk continued parochial arguing and temporizing as access to world markets shrinks.

Recommendation 6: Canada should pursue vigorously all available avenues for improving export market access and, at the same time, resist protectionism and trade-distorting subsidies at home. The debate on Canadian-U.S. bilateral negotiations should focus in 1987 on what trade-offs Canada should be prepared to make to achieve important restrictions on U.S. application of countervailing duties and voluntary export restraints on bilateral trade. In the multilateral arena, Canada, in concert with like-minded countries, should continue to press for an end to damaging export subsidies and other trade-distorting policies in agriculture; a rollback in protectionist practices, including voluntary export restraints that defy GATT principles; and stricter international rules on the use of contingent-protection laws, including countervailing duties. These two avenues are necessary, but Canada also should consider new bilateral initiatives in the Pacific Rim and Europe.

Conclusion

The policy agenda outlined in this chapter is complex and is one that will make heavy demands on Canada's leaders. In some areas, such as tax policy and unemployment insurance reform, Canada is like a person ordered at gunpoint to wade into a swamp. The swamp looks murky and dangerous but the consequences of refusing to move forward look worse. Changes should be made that are in the overall interests of the country. These will create short-term winners and losers. The federal government should consult on proposed changes. But having consulted, it must act.

In other areas, the task is no less formidable. It requires staying on course in pursuing sustained expansion, continued deficit reduction, and more secure access to export markets.

The objective is to increase Canada's economic flexibility and international competitiveness. The policy agenda required to achieve this objective will exist for years. In 1987, progress toward these long-term goals — not solutions to all problems — is required. Priorities can change based on unexpected economic developments and political pressures. But the agenda must survive. Policymakers will require vision and must provide leadership; private-sector participants will require a constructive, cooperative attitude to change. If these are present and the agenda is translated into action, Canada's ability to succeed in a changing world will be greatly strengthened.

Policy Analysis Committee

The C.D. Howe Institute Policy Analysis Committee (HIPAC) was formed in 1980 from the Canadian Economic Policy Committee, established in 1961. This change was brought about to help streamline the Institute's activities and to improve the process of accountability of staff to the Institute's members.

HIPAC's membership is drawn primarily from business and labor organizations that are members of the Institute. To encourage diversity of perspective, HIPAC also includes members from the academic world, from agricultural organizations, and from the professions. Two Regional Advisory Committees have been established across the country to assist HIPAC in determining its research agenda and to ensure that the research conducted by the Institute on its behalf is relevant and reflective of regional points of view.

Full meetings of HIPAC's membership are held twice each year. The purposes of these meetings are to hear expert speakers on current policies, to engage in frank discussion of topics raised by members, and to identify a research program that the Institute can carry out effectively to improve public understanding of important policy issues. The professional completion of this program is then supervised by the Institute, which coordinates with the HIPAC Executive Committee.

The Chairman of HIPAC is H.A. Hampson (Deputy Chairman and Chief Executive Officer, Canada Development Corporation).

Recent publications prepared in conjunction with HIPAC include:

- *Ontario's Proposals for the Canadian Securities Industry*, Observation no. 29, by Thomas J. Courchene, with John D. Todd and Lawrence P. Schwartz (November 1986).
- *Monetary Policy in Transition: A Study of Bank of Canada Policy, 1982–85*, Policy Study no. 1, by Peter Howitt (October 1986).
- *Staying on Course*, C.D. Howe Institute Commentary no. 12, by Peter F. Bartha (October 1986).
- *Closing a Trade Deal: The Provinces' Role*, C.D. Howe Institute Commentary no. 11, by Murray G. Smith (August 1986).
- *New Stresses on Confederation: Diverging Regional Economies*, Observation no. 28, by Edward A. Carmichael (June 1986).
- *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27, by Richard G. Lipsey and Murray G. Smith (May 1985).